SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1920.

No. 810.

THE UNITED STATES, APPELLANT,

vs.

C. W. PHELLIS.

APPEAL FROM THE COURT OF CLAIMS.

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IN THE UNITED STATES COURT OF CLAIMS.

C. W. PHELLIS, CLAIMANT,
vs.
THE UNITED STATES, DEFENDANT.

Filed April 10, 1920.
No. 34554.

I. *Petition.*

Claimant respectfully shows to the court:

1. That he is a citizen of the United States and a resident of the city of Wilmington, State of Delaware.

2. That on or about the 1st day of September, 1915, he was the owner in his own right of two hundred and fifty (250) shares of the common stock of the E. I. du Pont de Nemours Powder Company, a corporation organized and existing under the laws of the State of New Jersey.

3. That in September, 1915, the stockholders of E. I. du Pont de Nemours Powder Company, a New Jersey corporation, caused a reorganization of the business of said company to be made. At that time the company had outstanding the following stocks and bonds:

294,271 shs. com. stock, par $100	$14,166,000 4½% 30-year bonds
160,686 shs. pfd. stock, par $100	1,230,000 5% mortgage bonds
454,957	$15,396,000

2 The business had been carried on for a great many years and in September, 1915, had as capital and accumulated surplus employed in the business of manufacturing and selling explosives about $95,000,000. The stockholders, substantially all assenting thereto, organized a new corporation under the laws of Delaware, under the name of E. I. du Pont de Nemours & Company, with an authorized capital of $240,000,000, divided into 1,600,000 shares 6% debenture stock and 800,000 shares common stock, both of the par value of $100 each.

All the assets and good-will of the old company were transferred as an entirety and as a going concern to the new company October 1, 1915, the new company assuming all the liabilities of the old company, except capital stock and funded debt. In return therefor the old company received $1,484,100 in cash to be used in the redemption of its outstanding 5% mortgage bonds, $59,661,700 par value in debenture stock of the new company of which $30,234,600 were to be used in taking up share for share, and dollar for dollar, the 160,686 shares of the preferred stock of the old company and the 14,166 4½% 30-year bonds then outstanding against said old company, and $58,854,200 par value of the common stock of the new company for immediate distribution among the stockholders of the old company.

The personnel of the stockholders, directors, and officers of the new company on the date of the transfer were the same as that of the old company. Upon receipt by the old company of the cash and stock aforesaid it distributed to its stockholders two shares of the common stock in the new company for each one share of common stock of the old company held by its stockholders respectively. The old company also proceeded to redeem in cash all its outstanding 5% mortgage bonds, and has by an exchange of debenture stock therefor taken up substantially all of its outstanding pre-
3 ferred stock and all but about $2,000,000 of its 4½% bonds. Since October 1, 1915, it has transacted no business other than that incidental to the redemption of its securities as aforesaid, and is now in process of liquidation.

4. Under the common stock distribution aforesaid the undersigned, a stockholder of the old company, received in October, 1915, 500 shares of the common stock of the E. I. du Pont de Nemours & Company at par, which stock so received the undersigned did not include as income in his income-tax return for said year, being advised that the same was a stock dividend and as such not liable to the income tax.

5. That the value of said stock of said E. I. du Pont de Nemours & Company of Delaware, so received by claimant as aforesaid, was three hundred and forty-seven dollars and fifty cents ($347.50) a share at the time of its receipt by claimant in October, 1915, as aforesaid.

6. That all the assets of said New Jersey corporation passed to said Delaware corporation in exchange for the capital stock of said Delaware corporation issued to the said New Jersey corporation and distributed to its stockholders as aforesaid.

7. That said New Jersey corporation retained as its only assets the debenture stock of said Delaware corporation to an amount equal to the outstanding common stock of said New Jersey corporation, and the value of said debenture stock was ninety-five dollars ($95) per share, and said New Jersey corporation ceased to do any business from the month of October, 1915, as aforesaid.

8. That upon the completion of the reorganization above set out each original holder of one share of the common stock of said New Jersey corporation retained one share of said stock and held two shares of the common stock of the Delaware corporation, the shares so held by him representing the same assets of the original cor-
4 poration then held by the Delaware corporation and while each stockholder had three certificates where he had before held one, the three certificates represented exactly the same value as the one had represented and the holder was by said reorganization and the holding of said certificates no richer than he had been before.

9. That the distribution of said stock of the Delaware corporation to the holders of said stock of the New Jersey corporation was in

substance and in fact a stock dividend and as such was not taxable under the provisions of the Sixteenth Amendment to the Constitution of the United States.

10. That notwithstanding the facts above set out the Commissioner of Internal Revenue, conceiving said distribution of the stock of the Delaware corporation to be a distribution of property and not a stock dividend, on or about the 31st day of December, 1919, made an assessment of an additional tax of $5,657.95 against said claimant, under the provision of the Act of Congress approved October 3, 1913, based upon the value of said stock so received by claimant of $173,750, or $347.50 per share.

11. That claimant thereupon filed claim for abatement, but on or about the 20th day of February, 1920, claimant withdrew his claim for abatement and paid to the Collector of Internal Revenue at Wilmington, Delaware, the sum of $5,657.95 in payment of said assessment, taking said collector's receipt therefor, of which copy is hereto attached, marked Claimant's "Exhibit A," and prayed to be read as a part hereof. That said payment was made by claimant under protest, addressed to said collector, copy thereof being hereto attached marked Claimant "Exhibit B" and prayed to be read as a part hereof.

12. That thereafter claimant filed with the Commissioner of Internal Revenue claim for the refund to him of said $5,657.95, paid by him under protest as aforesaid, copy of said claim being hereto attached, marked Claimant's "Exhibit C," and prayed to be read as a part hereof. That on or about the 20th day of March, 1920, said claim for refund was denied by the Commissioner of Internal Revenue, copy of his decision being attached hereto, marked Claimant's "Exhibit D" and prayed to be read as a part hereof.

13. That notwithstanding said denial of refund there is justly due to claimant the sum of $5,657.95, so paid by him as aforesaid under protest.

14. That claimant has always borne true allegiance to the Government of the United States and has not in any way voluntarily aided, abetted, or given encouragement to rebellion against said Government. That he has not assigned his claim or any part thereof and that he is justly entitled to the amount herein claimed after allowing all just credits and offsets.

The premises considered: Claimant prays this honoroble court to enter judgment in his behalf against the defendant in the sum of $5,657.95, and for such other and further relief as may be required.

C. W. PHELLIS,
By FRANK S. BRIGHT,
His Attorney in Fact.

FRANK S. BRIGHT,
Attorney for Claimant.

DISTRICT OF COLUMBIA, *ss:*

Frank S. Bright, being first duly sworn, says that he is the duly appointed attorney in fact of C. W. Phellis, of Wilmington, State of Delaware, and as such has subscribed the foregoing petition, and that the statements therein made are true to the best of his information and belief.

FRANK S. BRIGHT,
Attorney in Fact of C. W. Phellis.

Subscribed and sworn to before me this 6th day of April, 1920.

KATHARINE A. GRACE,
Notary Public, D. C.

[SEAL.]

6

Form 1107

United States Internal Revenue

NOTICE TO TAXPAYER

Before presenting payment to cashier enter on this form—
(*a*) NAME
(*b*) ADDRESS
(*c*) FORM NUMBER OF RETURN
(*d*) AMOUNT OF TAX PAID

Claimant's Exhibit A

1915 Assessment by Commissioner

TAXPAYER'S RECEIPT FOR INCOME AND EXCESS PROFITS TAX

Office Collector Internal Revenue
Form No. of return_____ Tax, $5,657.95
Received payment,
H. T. GRAHAM
B.

Name: C. W. PHELLIS
Address: Wilmington, Delaware

Claimant's Exhibit B.

Wilmington, Delaware,
February 20, 1920.

H. T. GRAHAM, Esq.,
Collector of Internal Revenue,
Wilmington, Delaware.

SIR: I have heretofore received from you original notice and demand dated Dec. 31, 1919, for additional tax of $5,657.95 for the taxable year 1915, and against said assessment I have heretofore filed claim for abatement.

In order to get definitely settled at the earliest possible time my ultimate liability to pay said tax I have determined to withdraw my claim for abatement, pay the tax and file a claim for refund, and I am therefore handing you herewith check for $5,657.95 which I am paying to you under protest, for the reason that said assessment levies a tax under the provisions of the act of October 3, 1913, on 500 shares of the common stock of E. I. du Pont de Nemours & Company at the value of $347.50 per share received by me during the year

7 1915 as income, and said stock was not taxable income under the terms of said act of October 3, 1913, or any other statute applicable thereto, or within the terms of the sixteenth amendment to the Constitution, which provides for the collection of an in-

come tax. And claimant appends hereto copy of the statement of the circumstances of the issue and receipt of said stock that was appended to and made a part of claimant's return as originally filed, and respectfully shows that the circumstances thereof bring said distribution of stock well within the intent of the decision of the Supreme Court of the United States in the case of Towns v. Eisner, Collector, 245 U. S., 418, which declared stock dividends not to be taxable income.

I have to ask that receipt for the enclosed check may be returned to me forthwith.

Respectfully,

C. W. PHELLIS.

Encls.
P—

Claimant's Exhibit C.

(Copy.)

TREASURY DEPARTMENT
U. S. INTERNAL REVENUE
Form 46—Revised March, 1918
Ed. 150,000

CLAIM FOR REFUND.

Taxes Erroneously or Illegally Collected

Also Amounts Paid for Stamps Used in Error or Excess.

State of Delaware, }
County of Newcastle } *ss:*

IMPORTANT
This claim should be forwarded to the Collector of Internal Revenue to whom the tax was paid and must be accompanied by Collector's Receipt therefor.

C. W. PHELLIS,
Du Pont Bldg.,
Wilmington,
Delaware.

Date of filing to be plainly stamped here.

This deponent being duly sworn according to law deposes and says that this claim is made on behalf of the claimant named above, and that the facts stated below with reference to the claim are true and complete:

1. Business engaged in by claimant: Employee of E. I. du Pont de Nemours & Co.

2. Character of assessment or tax: Income tax for 1915, as per notice and demand, dated Dec. 31, 1919.

3. Amount of assessment or stamps: Five thousand six hundred fifty-seven and 95/100 ($5,657.95).

4. Amount now asked to be refunded (or such greater amount as is legally refundable): $3,657.95.

5. Date of payment of assessment or purchase of stamps: February ——, 1920.

Deponent verily believes that the amount stated in Item 4 should be refunded and claimant now asks and demands refund of said amount for the following reasons:

"Said assessment levies a tax under the provisions of the act of October 3, 1913, on 500 shares of the common stock of E. I. du Pont de Nemours & Company at the value of $347.50 per share received by me during the year 1915 as income, and said stock was not taxable income under the terms of said act of October 3, 1915, or any other statute applicable thereto, or within the terms of the sixteenth amendment to the Constitution, which provides for the collection of an income tax. And claimant appends hereto copy of the statement of the circumstances of the issue and receipt of said stock that was appended to and made a part of claimant's return as originally filed, and respectfully shows that the circumstances thereof bring said distribution of stock well within the intent of the decision of the Supreme Court of the United States in the case of Towne v. Eisner, Collector, 245 U. S., 418, which declared stock dividen ls not to be taxable income."

And this deponent further alleges that the said claimant is not indebted to the United States in any amount whatever, and that no claim has heretofore been presented, except as stated herein, for the refunding of the whole or any part of the amount stated in item 3.

Signed: C. W. PHELLIS.

Sworn to and subscribed before me this 20th day of February, 1920.
G. D. HOPKINS, *Notary Public.*

(This affidavit may be sworn to before a Deputy Collector of Internal Revenue without charge.)

9 *Claimant's Exhibit D.*

IT:CL
WLS
Mr. C. W. PHELLIS,
Du Pont Building,
Wilmington, Delaware.

SIR: Reference is made to your claim for the refund of $5,657.95 additional individual income tax for the year 1915.

You claim that the assessment of the additional tax was erroneous and illegal in that it was based upon an income of $173,750.00 represented by 500 shares of common stock of E. I. du Pont de Nemours & Co., of Delaware at the value of $347.50 per share received by you in 1915 which was not taxable income under the Act of October 3, 1913, and that "the circumstances thereof bring said distribution of stock well within the intent of the decision of the Supreme Court of the United States in the case of Towne vs. Eisner, Collector, 245 U. S., 418, which declared stock dividends not to be taxable income."

You submitted an individual income tax return for 1915 and were

assessed thereon an income tax of $90.04. Subsequently your accounts were investigated by a revenue agent who under date of August 30, 1919, reported that in October, 1915, you received 500 shares of the common stock of the E. I. du Pont de Nemours & Co., a Delaware corporation, as your proportionate part of a 200% dividend declared and paid by the E. I. du Pont de Nemours Powder Co., a New Jersey corporation, to its stockholders. The value of this stock dividend at the time you received it was $347.50 per share, or a total value of $173,750.00. In the preparation of your original income tax return, the income represented by this dividend was omitted therefrom.

The agent's report was audited and approved by this office resulting in the assessment and collection of the additional tax complained of.

The issue is whether the dividend in question, consisting of 500 shares of the common stock of the E. I. du Pont de Nemours & Co., of Delaware, declared and paid by the E. I. du Pont de Nemours Powder Co., of New Jersey, was income to you and subject to income tax under the act of October 3, 1913.

The facts as they appear from the bureau records are that on or about October 1, 1915, the E. I. du Pont de Nemours Powder Co., a New Jersey corporation, sold all of its corporate assets, including a large surplus accumulated practically entirely after the outbreak of the European war, to the E. I. du Pont de Nemours & Co., a Delaware corporation, organized in 1915, by substantially the same parties controling the New Jersey Co., receiving therefor stock of the Delaware Company, together with comparatively small amount of cash. The New Jersey Co., then declared and paid a dividend to its own common stockholders consisting of common stock of the Delaware Co., in the proportion of two to one; that is, for each share of common stock of the New Jersey Co., the stockholder received as a dividend two shares of stock of the Delaware Co. The New Jersey Co. did not at this time dispose of the entire amount of stock of the Delaware Co., but retained debenture stock of that company of par value equal to that of its own common stock outstanding. The stockholders of the New Jersey Co. did not surrender their stock in that company upon receipt of the dividend in stock of the Delaware Company, and it was not until January, 1918, that an opportunity was given by the New Jersey Company to make such exchange at which time the New Jersey Company declared a further dividend consisting of approximately 90% of the remaining debenture stock of the Delaware Company, which it had retained, and give its stockholders the option of exchanging their stock for the 10% yet remaining. The Delaware Company's common stock when distributed as a dividend of the New Jersey Co. had a fair market value of $347.50 per share, its par value being $100.00. The debenture stock of the Delaware Company had a fair market value at that time of about $95.00 per share, par value $100.00.

Since these two corporations were separate legal entities, the stock of the Delaware Company received by the New Jersey Company in exchange for all its assets is legally distinguishable from the
11 stock of the New Jersey Company, therefore, the distribution by the New Jersey Company, of the stock of the Delaware Company, as a dividend is not the distribution of a stock dividend and is not ruled by the case of Towne vs. Eisner. Neither was the distribution in the nature of a liquidating dividend for the reason that the New Jersey Company did not at the time of the sale nor immediately thereafter, dissolve but remained in existence retiring its bonds and preferred stock and as late as January, 1918, declared a further dividend out of its remaining assets consisting of more than $29,000,000.00 of the Delaware Company's debenture stock.

It is therefore held that the dividend in question was a distribution in specie of a portion of the assets of the New Jersey Company and is governed by the same rule applicable to a distribution of a like value in money.

Your claim for the refund of $5,657.95 additional individual income tax for 1915, is therefore hereby rejected.

Respectfully,

(Sgd.) PAUL F. MYERS,
Acting Commissioner.

ELM—4

12 II. *General traverse. Filed June 10, 1920.*

No demurrer, plea, answer, counterclaim, set-off, claim of damages, demand, or defense in the premises, having been entered on the part of the defendants, a general traverse is entered as provided by Rule 34.

III. *Argument and submission of case.*

On March 1, 1921, this case was argued and submitted on merits by Mr. Frank S. Bright and Mr. William A. Glasgow, jr., for the plaintiff, and Messrs. Assistant Attorney General Frank Davis, jr., and John M. Sternhagen, for the defendants.

13 IV. *Findings of fact, conclusion of law, and opinion of the court by Booth, J. Entered March 14, 1921.*

This case having been heard by the Court of Claims, the court, upon the evidence, makes the following

Findings of fact.

I.

Plaintiff, Charles W. Phellis, is a citizen of the United States and a resident of the city of Wilmington, State of Delaware.

II.

On and prior to September 1, 1915, the plaintiff was the owner of 250 shares of the common stock of the E. I. du Pont de Nemours Powder Co., a corporation organized and existing under the laws of the State of New Jersey, hereinafter called the New Jersey corporation.

III.

On the 19th day of August, 1915, the following letter was sent to the stockholders of the said New Jersey corporation, and the proposal therein made was very shortly thereafter assented to by 89.7 per cent of the holders of the stock of said company:

WILMINGTON, DELAWARE, *August 19th, 1915.*

To the stockholders of E. I. du Pont de Nemours Powder Company:

The business of our company has greatly increased in volume so that it has become necessary to materially increase our capital to provide for proper and economical operation. Your officers have given the problem long and serious consideration with the result that the board of directors have approved a plan for the readjustment of its financial affairs, which plan may be briefly summarized as follows:

A new corporation to be known as E. I. du Pont de Nemours & Company will be incorporated under the laws of the State of Delaware, which company will have three classes of stock, viz, 6 per
14 cent cumulative *nonvoting* debenture stock, 6 per cent cumulative *voting* debenture stock, and common stock.

Except as to voting powers the rights of both voting and nonvoting debenture stocks shall be identical and the charter will provide:

Debenture shares shall bear cumulative dividends at the rate of 6 per cent per annum.

Debenture shares may be called for payment at $125 per share.

No mortgage or other specific lien may be placed upon the whole or any part of the property of the company without the consent of 75 per cent in amount of the total debenture stock outstanding except that this provision shall not apply to purchase money mortgages or to the assumption of mortgages or liens upon property purchased, nor shall it prevent the pledge for the purpose of securing cash to be used in the ordinary course of the business of the company of securities at any time held and owned by the company, provided such cash advances are secured on obligations of the company with maturities not more than three years from date hereof.

In case of dissolution (whether voluntary or involuntary) debenture shares shall have preference over the common stock on distribution of assets to the par amount thereof plus accumulated dividends.

The voting debenture stock shall have equal voting rights with the common stock.

The nonvoting debenture stock shall have no voting privileges except (*a*) in the event the company shall fail to pay any dividend thereon and such default shall continue for a period of six months, in which event the voting and nonvoting debenture stockholders shall have the sole right of voting to the exclusion of the common stockholders for the ensuing year and for each year thereafter until the company shall pay all accrued dividends on said debenture stock; and (*b*) in the event of the net earnings of the company in any calendar year amounting to less than 9 per cent on the amount of debenture stock issued and outstanding during such calendar year then the nonvoting debenture stockholders shall have equal voting rights with the voting debenture stockholders and with the common stockholders, which voting rights shall continue until the net earnings of the company for some future calendar year shall equal 9 per cent on the amount of debenture stock issued and outstanding in such future year.

This new corporation, E. I. du Pont de Nemours & Company of Delaware, will purchase all the assets and assume all the liabilities of our company and will pay therefor the sum of $120,000,000 as follows: $1,484,100 in cash; $59,661,700 par value in debenture stock; $58,854,200 par value in common stock. This will be all the stock that will be issued by E. I. du Pont de Nemours & Company at this time.

Upon the consummation of said sale and when our company has received the stock of E. I. du Pont de Nemours & Company an offer will be made to purchase the outstanding bonds and preferred stock of our company as follows:

(*a*) 5 per cent bonds (outstanding $1,230,000). This issue will be called for redemption under the provisions of the mortgage and paid for in cash.

(*b*) 4½ per cent bonds (outstanding $14,166,000). An offer will be made to purchase these bonds at par, payable in 6 per cent nonvoting debenture stock of E. I. du Pont de Nemours & Company at par. Thus, a person holding $1,000 par value 4½ per cent bonds will receive in payment therefor $1,000 par value 6 per cent debenture stock.

(*c*) Preferred stock (outstanding $16,068,600). Our 5 per cent preferred stockholders will be given opportunity to accept either of the following offers:

For each $100 par value of our 5 per cent cumulative preferred stock there will be offered $100 par value 6 per cent cumulative *nonvoting* debenture stock of E. I. du Pont de Nemours & Company. Thus, a person holding one share of preferred stock may exchange it for one share of debenture stock which will result in a 20 per cent increase in annual income; or

For each $100 par value of our 5 per cent cumulative preferred stock there will be offered $83 1/3 par value 6 per cent cumulative

voting debenture stock of E. I. du Pont de Nemours & Company with the privilege to the holder of this voting debenture stock of exchanging for nonvoting debenture stock at any time prior to April 25th, 1916, receiving therefor $100 par value nonvoting debenture stock for each $83 1/3 of voting debenture stock.

(*d*) Common stock (outstanding $29,427,100). All of the common stock of E. I. du Pont de Nemours & Company, of Delaware, will be distributed to the common stockholders of our company as a dividend. In other words, a person holding one share of common stock in our company will continue to hold it and in addition will receive two shares of the common stock of E. I. du Pont de Nemours & Company.

The above plan has been worked out as the result of the most mature deliberation, and we are confident that it will appeal to our security holders as most desirable.

We, therefore, request you to sign the attached form of assent to the carrying out of this plan, and return it to us at your earliest convenience, being careful to sign exactly as your name appears on your stock certificate.

Any information in connection with the matters herein referred to will be cheerfully furnished upon request.

Respectfully submitted.

PIERRE S. DU PONT,
President.

Assent of stockholders.

(To be signed and returned to P. S. du Pont, president.)

Whereas the board of directors of E. I. du Pont de Nemours Powder Company have approved a plan for readjusting the financial affairs of that company, which plan may be summarized as follows:

(*a*) A new corporation to be known as E. I. du Pont de Nemours & Company will be incorporated under the laws of the State of Delaware, which company will have three classes of stock, viz, 6 per cent cumulative *voting* debenture stock, 6 per cent cumulative nonvoting debenture stock, and common stock. Except as to voting powers, the rights of each class of debenture stock shall be identical and
16 shall be as follows: Cumulative six per cent dividends payable quarterly, with preference upon any distribution of assets to the extent of $100 per share and accumulated dividends in case of dissolution (whether voluntary or involuntary); the nonvoting debenture stock to have voting rights in common with the voting debenture stock, and to the exclusion of the common stock in case the company shall fail to pay any quarterly dividend thereon, and such default shall continue for a period of six months and to have equal voting rights with the voting debenture stock and common stock in case the earnings in any year shall amount to less than nine per cent of the amount of debenture stock issued and outstanding; both classes of debenture stock to be redeemable at any dividend date at $125 per

share; no prior lien to be placed upon any of the property of the corporation without the consent of three-fourths of the combined debenture stock, but this shall not apply to current obligations for the procurement of working capital, which obligations shall not run for more than three years from the date thereof.

(*b*) To sell, assign, convey, and transfer to E. I. du Pont de Nemours & Company all the assets of every nature of E. I. du Pont de Nemours Powder Company, subject to all the liabilities of that corporation, including its bonds issues, and subject to any lien or charge securing any of said obligations, all of which obligations shall be assumed by E. I. du Pont de Nemours & Company.

In consideration therefor the Delaware corporation to pay $1,484,100.00 in cash, 588,542 shares of the common stock, and 596,617 shares of the debenture stock of E. I. du Pont de Nemours & Company.

(*c*) The E. I. du Pont de Nemours Powder Company to redeem its five per cent bonds at 105 per cent in cash; to offer to the holders of its 4½ per cent debenture bonds ten shares of said nonvoting debenture stock for each $1,000 of said bonds; to offer to the holders of its preferred stock at their option either one share of said nonvoting debenture stock for each share of said preferred stock, or $83⅓ par value of said voting debenture stock for each share of said preferred stock, and in case the latter option is exercised will further, at any time prior to April 25th, 1916, exchange any such voting debenture stock for nonvoting debenture stock by giving therefor one share of nonvoting debenture stock for each $83⅓ par value of said voting debenture stock;

And, whereas, under the charter of said E. I. du Pont de Nemours Powder Company, the written assent of two-thirds in amount of the stockholders of said company is necessary to said sale, conveyance, assignment, and transfer of its property, assets, rights, and privileges as an entirety;

Now therefore we, the undersigned stockholders of E. I. du Pont de Nemours Powder Company, hereby assent, for and on behalf of all the stock in said corporation held by us respectively, to the sale, conveyance, assignment, and transfer of all the property, assets, rights, and privileges of said corporation as an entirety to E. I. du Pont de Nemours & Company hereinbefore referred to and for the consideration hereinbefore mentioned; and we further authorize the directors of said corporation to take such steps as may be necessary to carry out the same.

17 This assent, however, shall not become effective until such time as E. I. du Pont de Nemours & Company shall have been organized, and the board of directors of said E. I. du Pont de Nemours Powder Company shall have passed resolutions authorizing said sale, conveyance, assignment, and transfer, as above provided, for the consideration above mentioned, and further shall have authorized the offers of exchange of the said securities of the said E. I. du Pont de Nemours & Company to the 4½ per cent bondholders and the

preferred stockholders of said New Jersey corporation, and shall have authorized the redemption of said five per cent bonds of said corporation.

This assent may be executed upon separate forms with the same force and effect as though executed upon one instrument.

_____ _____.
(Sign here.)

In presence of—

_____ _____

Dated the _____ day of August, 1915.

IV.

As a result of said proposal and the assent thereto of said stockholders the plan set out in said proposal was carried out. The E. I. du Pont de Nemours & Co., a corporation, was organized under the laws of the State of Delaware (hereinafter called the Delaware corporation) and the following agreement between the New Jersey corporation and the Delaware corporation was entered into on the 16th day of September, 1915:

An agreement made this 16th day of September, A. D. 1915, by and between E. I. du Pont de Nemours Powder Company, a corporation organized and existing under the laws of the State of New Jersey, hereinafter called the "vendor," of the first part, and E. I. du Pont de Nemours and Company, a corporation organized and existing under the laws of the State of Delaware, hereinafter called the "company," of the second part:

Whereas the vendor is the owner of the real, personal, and mixed property hereinafter described, which property the board of directors of the vendor, with the written assent of the holders of more than two-thirds of the capital stock of the vendor issued and outstanding, has offered to sell and convey to this company, as an entirety and as a going concern, for one hundred and twenty million dollars ($120,000,000), payable in cash and in the capital stock of this company as follows: One million four hundred and eighty-four thousand one hundred dollars ($1,484,100) in cash; fifty-eight million eight hundred and fifty-four thousand two hundred dollars ($58,854,200) in the common stock of the company at par, and fifty-nine million six hundred and sixty-one thousand seven hundred dollars ($59,661,700) in debenture stock of the company, of which debenture stock one hundred thousand (100,000) shares or any part thereof shall be voting debenture stock if demanded by the vendor; and

Whereas the company has been duly organized with an authorized capital stock of two hundred and forty million dollars ($240,000,000)
18 divided into one million five hundred thousand (1,500,000) shares of nonvoting debenture stock; one hundred thousand (100,000) shares of voting debenture stock, and eight hundred thousand (800,000) shares of common stock of the par value of one hundred dollars ($100) each; and

Whereas the board of directors of the company have ascertained, adjudged, and declared that the real, personal, and mixed property aforesaid are of the fair value of one hundred and twenty million dollars ($120,000,000), and that the acquisition thereof is necessary for the business of the company and to carry out its contemplated objects:

Now, therefore, this agreement witnesseth:

1. That the vendor hereby agrees to sell, assign, transfer, and set over to the company, its successors and assigns, all its right, title, and interest in and to the following described property, to wit: All of the vendor's real, personal, and mixed property of every kind, nature, and description on the date of transfer and wheresoever situate, including water rights and all fixtures and appurtenances to real estate and easements therein; all manufacturing plants and machinery, tools, and appliances used in connection therewith; all raw materials, manufactured products, and partially manufactured product wheresoever situated; all accounts and bills receivable; all stocks and bonds and all claims, demands, judgments, and choses in action of every kind, nature, and description; all patents, applications for patents, trade-marks, trade names, trade secrets, brands, and copyrights; all cash on hand and moneys in bank and all personal property of every kind, nature, and description.

The above enumeration is not to be taken as excluding any property or property rights not specifically mentioned in the above enumeration, but all the vendor's property, assets, rights, and privileges, including the good will of the business, is intended to be included in said sale. The real, personal, and mixed property above described to be sold and conveyed subject to the lien or charge imposed by that certain indenture made and executed June 1, 1906, between the vendor and the Guaranty Trust Company, of New York, as trustees, to secure the payment of an issue of sixteen million dollars ($16,000,000), par value of four and one-half per cent (4½ per cent) thirty-year gold bonds issued by the vendor, of which issue fourteen million one hundred and sixty-six thousand dollars ($14,166,000) par value are now outstanding and unpaid and subject to any and all other liens, mortgages, charges, or encumbrances of whatsoever kind and nature existing on the date of said sale. The consideration for said sale to be paid by the company shall be one million four hundred and eighty-four thousand one hundred dollars ($1,484,100) in cash, fifty-eight million eight hundred and fifty-four thousand two hundred dollars ($58,854,200) in the common stock of the company at par; and fifty-nine million six hundred and sixty-one thousand seven hundred dollars ($59,661,700) in debenture stock of the company, of which debenture stock one hundred thousand (100,000) shares or any part thereof shall be voting debenture stock if demanded by the vendor; nonvoting debenture stock to be accepted in payment of the purchase price at par and voting debenture stock at one hundred and

twenty dollars ($120) per share, with the option in the vendor at any time prior to April 25, 1916, to exchange voting debenture stock for nonvoting debenture stock on the same basis: i. e., this company shall be entitled to receive one hundred shares of nonvoting debenture stock for each eighty-three and one-third shares of voting debenture stock surrendered on or before April 25, 1916. The company shall also, as a part of the consideration for the property and business so sold, assume all the liabilities, debts, and obligations, contractual or otherwise, of every kind, nature, and description, due or to become due, of the vendor existing on the date of said transfer, except capital-stock liability and the funded debt of the vendor, consisting of one million two hundred and thirty thousand dollars ($1,230,000) of the five per cent (5 per cent) first mortgage and collateral trust gold bonds of the vendor now outstanding and unpaid, and fourteen million one hundred and sixty-six thousand dollars ($14,166,000) of the four and one-half per cent thirty-year gold bonds of the vendor now outstanding and unpaid.

2. The company hereby agrees, in consideration of said sale and upon the execution by the vendor of this agreement and the delivery to it of a good and sufficient bill of sale assigning, transferring, and conveying all of the personal property and personal property rights aforesaid, to pay to the vendor the sum of one million four hundred and eighty-four thousand one hundred dollars ($1,484,100) in cash and to issue to the vendor or to such nominees as the vendor shall in writing hereafter direct, at such times and in such amounts as the vendor directs, certificates of stock of the company as follows: Five hundred and eighty-eight thousand five hundred and forty-two (588,542) shares of the common stock of the company and five hundred and ninety-six thousand six hundred and seventeen (596,617) shares of the debenture stock of the company, of which debenture stock one hundred thousand (100,000) shares or any part thereof shall be voting debenture stock is demanded by the vendor, said voting debenture stock to be exchanged for nonvoting debenture stock at any time prior to April 25, 1916, at the option of the vendor upon the basis of exchange hereinbefore set forth. All shares of the capital stock of the company so issued in payment for the property aforesaid shall be deemed to be and are hereby declared to be full-paid shares and not liable to any further call, and the holders of such stock shall not be liable to any further payment thereon.

The company hereby agrees, as a part of the consideration for the sale of the property and business so sold, to assume and discharge all the liabilities, debts, and obligations, contractual or otherwise, of every kind, nature, and description, due or to become due, of the vendor existing on the date of said transfer, except capital-stock liability and the funded debt of the vendor hereinbefore specifically mentioned; and the vendor hereby agrees to hold the company harmless from the lien or charge on the property sold to secure the payment of the funded debt aforesaid.

3. It is agreed that any contract of the vendor existing on the date of said transfer that is not legally assignable without the consent of the other party or parties thereto shall be assigned subject to the assent to such assignment of such other party or parties thereto and, in the event any such other party or parties shall not assent to the assignment of any such contract, the vendor shall perform or cause to be performed the said contract for the use and benefit of E. I. du Pont de Nemours and Company and at its sole expense, and all moneys due or thereafter becoming due thereon shall belong to the company.

4. The vendor hereby covenants and agrees with the company, upon the request and at the cost of the company, to execute and to do all such further assurances and things as shall reasonably be required by the company for vesting in it the property and rights agreed to be hereby sold, and giving to it the full benefit of this agreement.

In witness whereof the parties hereto have caused this agreement to be signed in their respective corporate names by officers duly authorized so to do and their respective corporate seals to be affixed on the day and year first above written.

E. I. DU PONT DE NEMOURS POWDER COMPANY,
By PIERRE S. DU PONT, *President.*

Attest:
L. R. BEARDSLEE, *Asst. Secretary.*

E. I. DU PONT DE NEMOURS AND COMPANY,
By IRENEE DU PONT, *President.*

Attest:
ALEXIS I. DU PONT, *Secretary.*

I, Alexis I. du Pont, secretary of E. I. du Pont de Nemours and Company, hereby certify that the foregoing is a full and true copy of an agreement between E. I. du Pont de Nemours Powder Company and E. I. du Pont de Nemours and Company, dated the 16th day of September, 1915, as taken from and compared with the original agreement on record in my possession.

Witness my hand and the seal of the company this 14th day of May, 1920.

[SEAL.] ALEXIS I. DU PONT.

V.

On October 1, 1915, said New Jersey corporation, by bill of sale in pursuance of said proposal of August 19, and said agreement of September 16, transferred to the Delaware corporation all its assets of every description, said bill of sale reading as follows:

Know all men by these presents:

That E. I. du Pont de Nemours Powder Company, a corporation organized and existing under the laws of the State of New Jersey, of the first part (hereinafter referred to as "vendor"), in considera-

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iton of the sum of one million four hundred eighty-four thousand one hundred dollars ($1,484,100) cash, and other valuable consideration to it in hand paid by E. I. du Pont de Nemours and Company, a corporation organized and existing under the laws of the State of Delaware, of the second part (hereinafter referred to as the "vendee"), receipt whereof is hereby acknowledged, has bargained, sold conveyed, transferred, assigned, and delivered, and by these presents does bargain, sell, convey, transfer, assign, and deliver unto the said vendee all of the vendor's property and assets, and all of the vendor's personal property and personal property rights of whatsoever kind, nature, and description, and wheresoever situate, including the good will of its business, and all its trade-marks, trade names, trade
21 secrets, brands, and copyrights; and all its machinery, tools, and appliances, in and in connection with its manufacturing plants and otherwise; and all its raw materials, manufactured product and partially manufactured product, wheresoever situate; and all accounts and bills receivable; and all its stocks and bonds; and all its claims, demands, judgments, choses in action, matured or otherwise, of every kind, nature, and description; all its patents and applications for patents; and all cash on hand and money in bank; and also all horses, mules, and live stock of every kind, nature, and description, wheresoever situate; and all transportation fixtures and equipment of every kind, nature, and description, including all locomotives, freight cars, tank cars, and track material; and all ships, boats, tugs, barges, and vessels of every kind, nature, and description, and wheresoever situate, including chartered or rented vessels. The foregoing enumeration is not to be taken as excluding any personal property or personal property rights not specifically mentioned in the above and foregoing enumeration, but all the vendor's personal property, personal assets, and personal rights and privileges is intended to be included in said sale: *Provided, however*, That all the above-described and intended property is sold and conveyed subject to the lien or charge imposed by that certain indenture made and executed June 1, 1906, between the vendor and the Guaranty Trust Company of New York, as trustee, to secure the payment of an issue of sixteen million ($16,000,000), par value of four and one-half per cent (4½ per cent) thirty-year gold bonds issued by the vendor, of which issue fourteen million one hundred sixty-six thousand dollars ($14,166,000) par value are now outstanding and unpaid, and subject to any and all other liens, charges, and encumbrances of whatsoever kind and nature existing on the first day of October, 1915.

To have and to hold all and singular the said property and property rights unto the said vendee, its successors and assigns, absolutely, to its and their own use and behoof forever.

It is understood that any contract of the vendor now existing that is not legally assignable without the consent of the other party or parties thereto is hereby sold and assigned subject to the assent of such other party or parties to such assignment, and in the event that

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any such other party or parties shall not assent to the sale and assignment of any such contract, the vendor shall and does hereby agree to perform or cause to be performed the said contract for the use and benefit of the vendee, but at the sole cost and expense of the vendee, and all moneys due or thereafter becoming due thereon shall belong to said vendee.

The vendee hereby agrees as a part of the consideration for the sale of the property and rights so sold to assume and discharge all the liabilities, debts, and obligations, contractual or otherwise, of every kind, nature, and description, of the vendor, existing on the first day of October, 1915, whether due or to become due, excepting capital stock and funded debt liability of the vendor.

The vendor hereby agrees to hold the vendee harmless from any lien or charge on the property hereby sold to secure the payment of the said funded debt of the vendee.

The vendor, for itself, its successors and assigns, hereby covenants and agrees with the vendee, its successors and asigns, that
22 upon the request but at the cost of the vendee it will execute any and all such further assurances as shall reasonably be required for vesting in the vendee, its successors and assigns, the property and right, hereby sold and giving to it and them the full benefit of this conveyance.

In witness whereof the parties hereto have caused these presents to be executed in triplicate by their respective officers thereunto duly authorized, and their respective corporate seals to be hereto affixed and attested as of the first day of October, A. D. 1915.

E. I. DU PONT DE NEMOURS POWDER COMPANY.
By PIERRE S. DU PONT, *President.*

Attest:
ALEXIS I. DU PONT, *Secretary.*

E. I. DU PONT DE NEMOURS AND COMPANY.
By H. M. BARKSDALE, *Vice President.*

Attest:
L. R. BEARDSLEE, *Asst. Secretary.*

I, Alexis I. du Pont, secretary of E. I. du Pont Nemours Powder Company, hereby certify that the foregoing is a full and true copy of a bill of sale conveying all of the personal property and personal property rights of E. I. du Pont de Nemours Powder Company to E. I. du Pont de Nemours and Company, which bill of sale is dated the 1st day of October, 1915, as taken from and compared with the original bill of sale on record in my possession.

Witness my hand and the seal of the company, this 14th day of May, 1920.

[SEAL.] ALEXIS I. DU PONT, *Secretary.*

Pursuant to said agreement of September 16, 1915, and upon the execution and delivery of said bill of sale from the New Jersey cor-

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poration to the Delaware corporation, and to carry out the terms of said agreement, the Delaware corporation delivered to the New Jersey corporation 588,342 shares of its common stock of the par value of $100 per share and 596,617 shares of its debenture stock of the par values of $100 per share and of the accepted value of $59,661,700, and said New Jersey corporation retained $1,484,100 in cash with which to redeem its outstanding 5 per cent debenture bonds.

VI.

In addition to said debenture stock of said Delaware corporation said New Jersey corporation then held cash in the sum of $1,484,400 sufficient to pay its outstanding 5 per cent bonds to the amount of $1,230,000. It also held debenture stock of the Delaware corporation to exchange for the outstanding preferred stock of the New Jersey corporation to the amount of $16,068,801.34 and to exchange for the outstanding 4½ per cent bonds of said New Jersey corporation to the amount of $14,166,000, and further, said New Jersey corporation held the debenture stock of the Delaware corporation equal in amount to the outstanding common stock of the New Jersey corporation, and it also held two shares of the common stock of the Delaware corporation for each share of its, the New Jersey corporation, common stock outstanding.

23

VII.

Upon the execution of said transfers, in pursuance of said proposal of August 19 and said agreement of September 16, the New Jersey corporation distributed as of October 1, 1915, to each holder of its common stock two shares of the common stock of the Delaware corporation, and the original holders of the common stock of the New Jersey corporation continued each to hold his original shares of said stock, and as of October 1, 1915, the Delaware corporation took over all the assets (excepting the aforesaid $1,484,100) theretofore held by the New Jersey corporation, and the New Jersey corporation thereafter held the cash and the debenture stock above described. Plaintiff received his 500 shares of the common stock of the Delaware corporation and continued to hold his original 250 shares of the common stock of the New Jersey corporation.

VIII.

The personnel of stockholders and officers of the two corporations was, on October 1, 1915, identical, the Delaware corporation having elected the same officers as the New Jersey corporation, and said holders of common stock of said corporations had each the same proportionate stock holding in both corporations; that is to say, on October 1 each owner of one share of stock of the New Jersey corporation was also the owner of two shares of stock of the Delaware corporation.

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IX.

The New Jersey corporation has received as income upon the debenture stock of the Delaware corporation held by it against its capital stock dividends to the amount of 6 per cent per annum, which it has paid out to its preferred and common stockholders, including plaintiff.

X.

The New Jersey corporation, after the distribution of the stock of the Delaware corporation, continued as a going concern and is still in existence, but, except for the collection and payment of said dividends and the redemption of its outstanding bonds, and the exchange of debenture stock for its preferred stock and the holding of the debenture stock of the Delaware corporation to an amount equal to the outstanding common stock of the New Jersey corporation, said New Jersey corporation has done no business and is not in process of liquidation.

XI.

The fair market value of the stock of the New Jersey corporation on the 30th day of September, 1915, was $795 per share, and the fair market value of the stock of said New Jersey corporation, after the execution of the contracts between two corporations, was, on October 1, 1915, $100. The fair market value of the stock of the Delaware corporation, distributed as aforesaid, was, on October 1, 1915, $347.50 per share.

12 XII.

In making his income-tax return for the year 1915, plaintiff, upon the advice of counsel, did not include as income the 500 shares of stock of the Delaware corporation received by him as aforesaid, but attached a statement as to the receipt of said stock to his income-tax return stating he did not regard it as taxable income.

XIII.

After an investigation of his books the Commissioner of Internal Revenue, holding that the 500 shares of stock of the Delaware corporation was income, and that its market value when acquired by claimant, October 1, 1915, was $347.50 per share, assessed an additional tax against claimant upon the 31st day of December, 1919, for income claimed by him to be due from plaintiff for the year 1915 because of the receipt by him of said stock, said assessment being in the sum of $5,657.97. Plaintiff first filed a claim for the abatement of said assessment, but thereafter withdrew his said claim for abatement, and on February 20, 1920, paid to the collector of internal

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revenue at Wilmington, Del., under protest, the amount of said assessment, to wit, $5,657.97, and upon the same day filed with the collector his claim for refund, which was denied by the Commissioner of Internal Revenue, whereupon plaintiff brought this suit.

Conclusion of law.

Upon the foregoing findings of fact the court decides, as a conclusion of law, that plaintiff is entitled to recover the sum of $5,657.97.

It is therefore adjudged and ordered by the court that the plaintiff recover of and from the United States the sum of five thousand six hundred and fifty-seven dollars and ninety-seven cents ($5,657.97).

Opinion.

BOOTH, *Judge*, delivered the opinion of the court:

The plaintiff was the owner of 250 shares of the E. I. du Pont de Nemours Powder Co., a New Jersey corporation. In September, 1915, a complete reorganization of the business of the company took place, and as the result of the same the plaintiff found himself the owner of his original shares in the New Jersey corporation and 500 shares in the new Delaware corporation. The defendants treated the new 500 shares of stock in the Delaware corporation as income, and assessed against them at their fair market value an income tax of $5,657.97, which plaintiff paid under protest. The facts are in no wise controverted and the findings disclose the exact situation.

In *Eisner* v. *Macomber*, 252 U. S., 189, 207, the Supreme Court, speaking of income, said:

"The gain derived from capital, from labor, or from both combined, * * * profit gained through a sale or conversion of capital assets, * * * not a gain accruing to capital, not a growth or increment of value in the investment, but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being 'derived,' that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit, and disposal—that is, income derived from property. Nothing else answers the description."

Again, in the same case the Supreme Court used the following language (p. 206):

"In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress can not by any definition it may adopt conclude the matter,

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since it can not by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

Subjecting the facts herein to the rule announced, we find as the admitted status the following situation, viz: On September 30, 1915, the plaintiff's 250 shares in the New Jersey corporation were worth on the market $795 each, or the total sum of $198,750. On October 1, 1915, the day he received his 500 shares additional in the new Delaware corporation, his 250 shares in the New Jersey corporation decreased in value $695 a share, and were then marketable at $100 per share, while the 500 new shares he received were worth in the open market $347.50 each, or a total value of $173,750. Adding this amount to the decreased value of his New Jersey corporation stock, we find the plaintiff in exactly the same situation as to the value of his holdings in both corporations that he was prior to the reorganization. The figures indisputably demonstrate that by the transaction the plaintiff did not gain or lose a penny, as will with more precision appear from the following tabulation:

Sept. 30, 1915, 250 shares of stock of the New Jersey corporation, at $795 each	$198,750
Total value Sept. 30, 1915	198,750
Oct. 1, 1915, 500 shares of stock of the Delaware corporation, at $347.50	173,750
Oct. 1, 1915, 250 shares of stock of the New Jersey corporation, at $100	25,000
Total value of the 750 shares in both	198,750

As a matter of fact if the position of the defendants is to be sustained the plaintiff herein instead of receiving an income from the transaction loses $5,657.97 which he must pay from gains derived from a source other than the one in controversy, or out of his original investment.

The defendant contends that the New Jersey and Delaware corporations must be regarded as "separate and distinct legal entities" and that the case is within the rule of *Peabody* v. *Eisner*, 247 U. S. 347. We think the whole transaction is to be regarded as merely a financial reorganization of the business of the company and that this view is justified by the power and duty of the court to look
26 through the form of the transaction to its substance. In *Eisner* v. *McComber*, 252 U. S., 189 at 213, it is said:

"We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable without apportionment."

It seems incredible that Congress intended to tax as income a business transaction which admittedly produced no gain, no profit, and hence no income. If any income had accrued to the plaintiff by reason of the sale and exchange made it would doubtless be taxable.

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Judgment will be awarded plaintiff in the sum of $5,657.97. It is so ordered.

Graham, *Judge;* Hay, *Judge;* Downey, *Judge;* and Campbell, *Chief Justice*, concur.

27 V. *Judgment of the court.*

At a Court of Claims held in the city of Washington on the fourteenth day of March, A. D. 1921, judgment was ordered to be entered as follows:

The court, upon due consideration of the premises, find in favor of the plaintiff, and do order, adjudge, and decree that C. W. Phellis, as aforesaid, is entitled to recover and shall have and recover of and from the United States the sum of five thousand six hundred and fifty-seven dollars and ninety-seven cents ($5,657.97).

By the Court.

VI. *Defendant's application for and allowance of an appeal.*

From the judgment rendered in the above-entitled cause on the 14th day of March, 1921, in favor of the claimant, the defendants, by their attorney general, on the 17th day of March, 1921, make application for, and give notice of, an appeal to the Supreme Court of the United States.

Annette Abbott Adams,
Assistant Attorney General.

Filed, March 17, 1921.

Ordered: That the above appeal be allowed as prayed for.

By the Court.

March 17, 1921.

28 Court of Claims.

C. W. Phellis
vs.
The United States. } No. 34554.

I, F. C. Kleinschmidt, assistant clerk Court of Claims, certify that the foregoing are true transcripts of the pleadings in the above-entitled cause; of the argument and submission of case; of the findings of fact and conclusion of law; of the opinion of the court by Booth, J.; of the judgment of the court; of the defendant's application for and allowance of an appeal to the Supreme Court of the United States.

In testimony whereof I have hereunto set my hand and affixed the seal of said Court at Washington City this 18th day of March, A. D., 1921.

[seal.]

F. C. Kleinschmidt,
Assistant Clerk Court of Claims.

(Indorsement on back:) File No. 28,167, Court of Claims. Term No. 810. The United States, appellant, vs. C. W. Phellis. Filed March 19th, 1921. File No. 28,167.

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In the Supreme Court of the United States.

OCTOBER TERM, A. D. 1921.

THE UNITED STATES, APPELLANT,
v.
C. W. PHELLIS, APPELLEE.
No. 260.

Appeal from the Court of Claims.

BRIEF FOR APPELLANT.

STATEMENT OF THE CASE.

This is an appeal from a final judgment entered upon petition and answer by the Court of Claims in favor of the appellee in a suit to recover $5,657.95 income taxes alleged to have been illegally assessed and collected for the year 1915, under the provisions of the income-tax law of October 3, 1913, upon $173,750, the value of 500 shares of common stock of E. I. du Pont de Nemours & Company, *a Delaware corporation* (hereinafter referred to as the Delaware corporation), received by the appellee as a dividend by reason of the ownership of 250 shares of common stock in the E. I. du Pont de Nemours Powder Company, *a New Jersey corporation* (hereinafter referred to as the New Jersey corporation).

I.

THE STATUTE.

The applicable parts of the income tax act of October 3, 1913 (38 Stat. 114, 166), are as follows:

> A. Subdivision 1. That there shall be levied, assessed, collected and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year to every citizen of the United States, whether residing at home or abroad, and to every person residing in the United States, though not a citizen thereof, a tax of 1 per centum per annum upon such income, except as hereinafter provided; * * *.
>
> Subdivision 2. In addition to the income tax provided under this section (herein referred to as the normal income tax) there shall be levied, assessed, and collected upon the net income of every individual an additional income tax (herein referred to as the additional tax) of 1 per centum per annum upon the amount by which the total net income exceeds $20,000 and does not exceed $50,000, and 2 per centum per annum upon the amount by which the total net income exceeds $50,000 and does not exceed $75,000, 3 per centum per annum upon the amount by which the total net income exceeds $75,000 and does not exceed $100,000, 4 per centum per annum upon the amount by which the total net income exceeds $100,000 and does not exceed $250,000, 5 per centum per annum upon the amount by which the total net income exceeds $250,000 and does not exceed $500,000, and 6

per centum per annum upon the amount by which the total net income exceeds $500,000. All the provisions of this section relating to individuals who are to be chargeable with the normal income tax, so far as they are applicable and are not inconsistent with this subdivision of paragraph A, shall apply to the levy, assessment, and collection of the additional tax imposed under this section. Every person subject to this additional tax shall, for the purpose of its assessment and collection, make a personal return of his total net income from all sources, corporate or otherwise, for the preceding calendar year, under rules and regulations to be prescribed by the Commissioner of Internal Revenue and approved by the Secretary of the Treasury. * * *

B. That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits, and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent: * * *.

II.

THE FACTS.

In September, 1915, and prior thereto, the New Jersey corporation was engaged in the business of manufacturing explosives. At that time its stock and funded debt were as follows:

Five per cent mortgage bonds	$1,230,000
Four and one-half per cent 30-year bonds	14,166,000
Preferred stock (par value $100)	16,068,600
Common stock (par value $100)	29,427,100
Total	60,891,700

The world war, which had broken out in 1914, had naturally caused a very great development of the company's business, so much so that in September, 1915, its assets with prior accumulations of profits were valued by the company's directors at $120,000,000. It thus appears that the company, prior to September, 1915, had amassed a surplus of at least $74,505,000, or a surplus over capital stock and funded indebtedness of $59,108,900.

On August 19, 1915, a plan, approved by the board of directors of the New Jersey corporation for the creation of a new corporation, to be known as E. I. du Pont de Nemours & Company, to be incorporated under the laws of the State of Delaware, was submitted to the stockholders of the New Jersey corporation. This plan is too intricate to be summarized and must be examined in full. (See Rec. pp. 9–13.) It proposed the sale of all the plant and other assets of the New Jersey corporation

to a new company with a larger capitalization to be formed under the laws of Delaware. The authorized capital of the new company was to be $240,000,000. Under this plan the Delaware corporation was to purchase all of the assets and assume all the liabilities of the New Jersey corporation and pay therefor in stock amounting in par value to $120,000,000, as follows:

Cash	$1,484,100
Debenture stock	59,661,700
Common stock	58,854,200

The New Jersey corporation, after reserving enough Delaware stock to pay off or retire the funded debt and preferred stock of the New Jersey corporation, *and enough to equal in value its outstanding common stock*, was then to declare and pay *as a dividend* to the holders of its common stock (outstanding $29,427,100) two shares of the common stock of the Delaware corporation for each share held in the New Jersey corporation. This was not an exchange of stock, but a dividend distribution. The New Jersey stockholder retained his stock upon which the dividend was declared. The New Jersey corporation was to redeem its five per cent bonds (outstanding $1,230,000) in cash, and to retire its four and one-half per cent bonds (outstanding $14,166,000) and its preferred stock (outstanding $16,068,600) by offering to their holders debenture stock of the Delaware corporation. (Finding III, Rec. pp. 9–11.) It then kept in its treasury $29,427,100 of the debenture stock of the Delaware corporation, on which cash dividends were paid to the New Jersey stockholders (Find-

ings IV and X, Rec. p. 20), *and the surplus* of the common stock of the Delaware corporation, amounting to $58,854,200—exactly twice as much as the outstanding common stock of the New Jersey corporation—was to be distributed to the latter company's stockholders as a dividend. Each New Jersey stockholder thus received two shares of Delaware stock for each share of New Jersey stock, and, as stated, *he retained his New Jersey stock and that company was to be continued as a going business.*

The plan contemplated not merely a change in corporate ownership, but a reclassification of stockholders with respect to voting power and a large potential increase of capitalization. The New Jersey stockholder would not only have two shares of the Delaware stock for each share of the New Jersey stock which he retained, but his New Jersey stock would itself be in an improved position, by reason of the fact that not only the funded indebtedness was to be retired, but also the outstanding preferred stock of the New Jersey corporation (which, as stated, amounted to $16,068,600) was to be retired. When thus retired, the New Jersey common stockholder, who held one share, instead of owning $\frac{1}{454957}$ of the New Jersey assets, would hold $\frac{1}{294271}$ interest.

Similarly, with reference to the Delaware company, the relative positions of its stockholders were on a different proportionate basis, for its stock was not only greater in amount *but was differently classified.*

The Delaware corporation, as organized, had an authorized capital stock of $240,000,000, divided into

1,500,000 shares of nonvoting debenture stock; 100,000 shares of voting debenture stock; and 800,000 shares of common stock. Of this total authorized capital, the Delaware company, at the time mentioned, only issued 1,200,000 shares, or $120,000,000, all of which was transferred to the New Jersey corporation, as follows: 588,542 shares of the common stock, 100,000 shares of *voting* debenture stock, 496,617 shares of *nonvoting* debenture stock. A relatively small cash payment completed the full purchase money.

The remaining $120,000,000 of authorized capital stock of the Delaware corporation was not issued at the time, but could be issued whenever the directors so decided.

Thus, an individual, who held shares of Delaware stock, did not stand in the same relation to his fellow stockholders in that company as he did with reference to his associate stockholders in the New Jersey corporation, by reason of the different classifications of stock; and this was further complicated by privileges for conversion, under which nonvoting stock might become voting stock.

Two corporations, each to continue in business, were thus proposed, differing in character and purpose.

The sale was agreed to by the stockholders of the New Jersey corporation and a formal agreement was entered into on September 16, 1915, to carry out the terms upon the conditions above indicated.

On October 1, 1915, the New Jersey corporation, by a bill of sale, transferred to the Delaware corporation all of its assets, and the Delaware corporation thereupon paid to the New Jersey corporation the cash payment above referred to and issued to it 588,542 shares of the common stock and 596,617 shares of its debenture stock. (Rec. p 19.)

The New Jersey corporation declared and paid on October 1, 1915, *as a dividend* to each holder of its common stock two shares of the common stock of the Delaware corporation. The New Jersey corporation after the payment of this dividend in specie to its stockholders thereafter held the cash and the debenture stock of the Delaware corporation, and also stock equivalent in amount to the outstanding New Jersey stock, and with these capital assets it has continued to pay cash dividends to its stockholders. (Findings IX and X, Rec. p. 20.)

After the declaration and payment of the dividend in the common stock of the Delaware corporation, the New Jersey corporation continued as a going concern, *is still in existence, and is not in process of liquidation.* (Finding X, Rec. p. 20.)

As stated, it has income yielding assets equal to its entire capital stock. *The distribution of a part of the Delaware stock as a dividend in specie, therefore, was a distribution by the New Jersey corporation of a part of its large surplus.*

On and prior to September 1, 1915, the appellee was the owner of 250 shares of the common stock of the New Jersey corporation (Finding II, Rec. p. 9)

and therefore under the plan above described he received on October 1, 1915, *as a dividend*, 500 shares of the common stock of the Delaware corporation and continued to hold his original 250 shares of the New Jersey corporation (Finding VII, Rec. p. 19).

In his income-tax return for the year 1915, the appellee did not include as income the 500 shares of stock of the Delaware corporation received by him. (Finding XII, Rec. p. 20.) The Commissioner of Internal Revenue ruled that the 500 shares of stock of the Delaware corporation constituted income, and that its market value when acquired by the appellee, October 1, 1915, was $347.50 per share, a total of $173,750. On December 31, 1919, an additional income tax for the year 1915 in the sum of $5,657.95 was assessed against the appellee. On February 20, 1920, the appellee paid the above tax under protest and filed a claim for refund, which was rejected by the Commissioner of Internal Revenue. Suit was thereupon brought by the appellee in the Court of Claims. (Finding XIII, Rec. p. 20–21.)

On March 14, 1921, the Court of Claims gave judgment for the appellee in the sum of $5,657.97 (Rec. p. 21).

On March 17, 1921, an appeal was taken by the United States to this court (Rec. p. 23).

III.

ASSIGNMENT OF ERROR.

The Court of Claims erred in holding that the dividend paid by the New Jersey corporation to its stockholders in the stock of the Delaware corpora-

tion was a stock dividend and did not constitute income within the meaning of the sixteenth amendment to the Constitution of the United States and the income tax act of October 3, 1913.

IV.

ARGUMENT.

The stock of the Delaware corporation, distributed as a dividend in specie to the stockholders of the New Jersey corporation, was income and did not constitute, either in form or substance, a stock dividend.

In limine, let me impress upon the court that this was not a case of a company, as in *Eisner* v. *Macomber*, 252 U. S. 189, having a large surplus, which after transferring to capital account was capitalized by the increase of new stock and such new stock distributed among its stockholders. Had the New Jersey company increased its capitalization from $29,427,100 to $120,000,000, to represent the value of their property, and thereupon issued new shares of *its own* stock to its stockholders, there can be no question that, under the decision in *Eisner* v. *Macomber*, it would not be income. In that event, the plaintiff, instead of having certificates for 250 shares, would have had certificates for approximately 1,000 shares. His interest in the property would have been no greater and no less, and the mere duplication of his certificates would not be income within the meaning of the Income Tax Act or of the Constitution. This I recognize and accept.

But what was done, as previously shown in my statement of facts, is something quite different.

The New Jersey corporation had a large surplus, far in excess of its capital stock. When it was acquired does not appear except by inference, but it can be safely assumed that much of it had come to the corporation by the abnormal activities of the first year of the great war. The corporation could have distributed this surplus to its stockholders in many ways.

(1) They could have distributed the vast surplus in cash. If so, it can not be questioned that it would have been income. (2) They could have distributed it in specie, either as securities or, if divisible, tangible property. It is equally clear that such distribution would have been income.

The corporation, however, decided to sell its entire plant to a new corporation. The fact that the new corporation was formed by the managing body of the old corporation and that there was a momentary identity of stockholders—although holding stock in different proportions and relations—can not in any way affect the question. They formed the new corporation in another State and with such franchises as that State granted corporations of this character.

Whether these franchises, as granted by the State of Delaware, were the same or different from the franchise granted to the old company by the State of New Jersey does not appear. Presumably, the promoters of the new company found some advantage in securing a different corporate situs.

Apart from the question of corporate franchises, the new corporation was to be constructed on a different basis from the old. Instead of having a capital issue of $45,495,100, the new corporation had an authorized capital stock of $240,000,000.

The relations between the stockholders *inter sese* were likewise changed. In the old corporation they were classified into common and preferred stock in the proportions that $29,427,100 bears to $16,068,000, respectively, while in the Delaware corporation there were to be three classes of stock, with a substantial variance in power. These holdings, independent of special privileges, were as 800,000 shares of common stock to 1,600,000 shares of debenture stock, and the debenture stock[1] was itself divided between 1,500,000 shares of non-voting debenture stock (which in certain contingencies might thereafter become voting stock) and 100,000 shares of voting stock.

Moreover, the Delaware company retained in its treasury $120,000,000 of stock which was not issued; but, as it was authorized, its possible issue was contemplated. Therefore, potentially, the relative pro-

[1] It is not clear from the statement of facts just what "debenture stock" is. The expression is an English one, and, instead of representing stock in the American sense of the word, it represents in English law an unsecured bond with an absolute obligation to pay principal and interest at fixed times. (Cook on Corporation, Vol. 3, sec. 777.) I assume that the debenture stock now in question simply meant a preferred stock with a fixed cumulative return. But, for the purposes of this argument, it is not important whether the so-called stock was, in fact, a bond or preferred stock in the true sense of the word.

portions of the common owners of this property would be very much changed, and the stockholders greatly augmented in numbers, if and when one-half of the whole capital stock of the new corporation was, as was possible, sold to the public.

The New Jersey company continued its operations as a company. Thenceforth it had the stock in question, out of which it proceeded to retire its bonded indebtedness and, so far as possible, its preferred stock, and held the precise equivalent of its common stock in valuable interest bearing assets, and a large surplus, which it divided among its stockholders.

Nothing prevented the New Jersey company from taking its existing assets, purchasing a new plant, and proceeding with the manufacture and sale of explosives in competition with the Delaware company.

For all legal and practical purposes the two corporations were separate. The New Jersey corporation owed its duty to the State that had created it. The Delaware company owed its duty to the State that had created it.

It is true that, for the time being, the management of both was identical. How long such management would remain identical would depend upon the will of the stockholders, for obviously the stockholders of the New Jersey corporation could, if they chose, select a new management just as the Delaware company could have done. In the case of the Delaware company the possibility of such a change in management would naturally be greatly increased if they sold the unissued capital stock,

being one-half thereof, to the public. It is also true that there was a momentary identity in stockholders, but as the stock was sold on the exchanges, this identity soon ceased.

It may be said that much of this rests upon possibilities. But when we are considering the question as to whether these two corporations are or are not separate entities, the possibilities or potential powers affect the question quite as much as the temporary realities. In other words, I earnestly submit that the technical and, as I think, the substantial difference between these two corporate entities is not destroyed by a temporary identity in the personnel of their management.

Much will be said in the argument of my opponents that in considering this question of identity the court must disregard form and consider substance.

I agree, and need only reply that, judged by substance, these two corporations are separate for all practical purposes, including taxation.

If a creditor of the New Jersey company sued the Delaware company on his debt, he would speedily realize the substantial difference between them.

If an employee of the Delaware company, injured in an accident, would sue the New Jersey company, he would speedily be disillusioned as to their identity.

Are the assets of the Delaware company longer liable for the bonded indebtedness of the New Jersey company?

Could a stockholder of the latter maintain a stockholder's bill against the former?

If the Delaware corporation had become insolvent, could the creditors of the New Jersey corporation ask that they share with the Delaware corporation's creditors in the distribution of its assets?

If the State of New Jersey sued the Delaware company for franchise taxes, or the State of Delaware sued the New Jersey company for such taxes, would not these States *in a matter of taxation* speedily realize that their separation was in substance and not merely in form?

Is the United States the only taxing power that must be defeated in its claim for taxes on the ground that in substance, though not in form, the two corporations were one?

My opponents may argue that there is no analogy between these illustrations and the instant case, for the reason that the contingencies referred to in the above questions would arise *in futuro*, whereas the instant case deals with a distribution of securities by the New Jersey company, which took place contemperaneously with the sale of its assets and the payment of the purchase price. I reply that it is not important when these transactions took place, *but what was their essential character.*

Suppose that the New Jersey corporation, having received the stock of the Delaware company in payment of the former's assets, had deferred a distribution of such Delaware stock among the New Jersey stockholders for a year and in the meantime had collected the income from such stock and used it for

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corporate purposes. Would the case be different in principle?

I think not, for it does not matter when the New Jersey corporation distributed the Delaware stock.

The controlling question is, Was this distribution by the New Jersey company of Delaware stock a distribution of surplus earnings, or was it merely a duplication of its own certificates, representing the same proportionate interest in the capital assets of the New Jersey corporation?

It is not denied that, whatever the nature of this dividend may be, it represented a distribution of *surplus* profits, which had been accumulated by the New Jersey corporation, for the capital assets of that corporation remained intact. Moreover, and of greater importance, the Delaware stock represented corporate interests in assets, *which had been severed from the New Jersey corporation by alienation.* Thenceforth the New Jersey stock could not be regarded as representing proportionate interests in the plant and assets thus conveyed. Thenceforth the New Jersey stockholders owned proportionate interests in certain securities of another corporation, which were not only potentially but in fact different from the securities of the New Jersey corporation.

This may be illustrated by an analogous situation. Suppose that the New Jersey corporation had wished to distribute its large surplus, but preferred to do so in specie, and had segregated enough of the assets to represent its existing surplus, say, $75,000,000.

Suppose it had transferred such segregated assets to its stockholders and they had formed a new corporation, which, in turn, purchased these assets.

Can it be questioned that the New Jersey stockholders would have been liable for a tax upon the value of the surplus which they thus received in specie?

If the analogy be true, it necessarily follows that the plant and other assets of the New Jersey corporation were as completely severed from that corporation when it sold them to the Delaware company as if it had distributed such assets, in the illustration used, to the stockholders direct.

This severance of title and this creation of a new corporation can not be obscured because of the temporary identity of the individuals who first constituted one company and then, for their own purposes, incorporated another. It is true that the personality of a corporation is, in a sense, a fiction of the law, but important rights and obligations depend upon the observance of such fiction. A corporation is, however, not a fiction, but an important business instrumentality. The individuals who, owning the New Jersey company, saw fit to form the Delaware company and transform the tangible assets of the former to the latter, believed, and had reason to believe, that there was an advantage in two different corporate personalities. Each such corporate entity conferred upon these individuals valuable rights. The individuals might come and go. Some might

sell their interests and others might die; but the corporations, having potential immortality, continued.

As previously shown, the promoters not merely readjusted finances, but also the relative rights of stockholders, and they acquired distinct and valuable rights in continuing their operations through two different corporate entities. Enjoying these rights, by reason of a legal device, is there injustice in asking them to accept some of the obligations of the so-called fiction of the corporate entity, which is of such value that the whole business of the modern world is largely transacted by the utilization of such instrumentality?

I shall hereafter discuss the many cases which justify my contention that the New Jersey and Delaware corporations, even if formed by the same group of individuals and for a common purpose, are yet for all purposes, including taxation, separate entities. I will now only quote from the opinion of a very able district judge, rendered in two cases which, it is anticipated, will be argued with the instant case. I refer to the cases of *New York Trust Company, Executors, etc.*, v. *Edwards, Collector*, and *United States* v. *John D. Rockefeller*, which, under a somewhat similar state of facts, were decided in favor of the Government by Judge Learned Hand on August 3, 1921. In those cases the taxpayers relied, in part, upon the decision of the Court of Claims in the instant case, but Judge Hand found himself unable to accept such ruling. He said:

Phellis v. *United States*, Court of Claims, March, 1921, was a case where all the assets were sold to another corporation, which, omitting irrelevant details, gave its own shares, two for one, to the old stockholders and conveyed its debenture shares to the old company par for par. The result was that the old stockholders had their old shares now represented by the assets of the old corporation, *i. e.*, the debenture shares in the new corporation, and double their original holdings in common shares of the new corporation. Whatever may be the proper answer to the case, with the greatest deference I can not follow the reasoning of the learned judge, now urged upon me as authoritative. That reasoning is that because the joint value of the old and new shares after the transfer was the same as that of the old shares before, there can have been no income to the stockholder. It may, of course, happen that in the case of the distribution of the dividends, the value of the old shares does not fall as much as the value of the dividend, though generally the correspondence is pretty close. It does not make any difference for taxing purposes whether it does or not. The surplus declared as dividend may or may not be represented in the value of the shares, but even though it be fully represented, the dividend becomes income as soon as the stockholder gets it. On his books it may appear as a capital distribution, depending on whether he carries his investment at par. That is not to the point. It was not his property before; it has become such by the declaration of the dividend.

Judge Hand's reasoning seems to me more convincing than that of the Court of Claims in the instant case, which based its conclusion largely upon the inconclusive fact that the market value of the New Jersey and Delaware stock in the stockholders' hands after the dividend was the same as the value of the New Jersey stock before the dividend. This normally happens whenever a corporation declares a dividend. It generally loses in market value by the amount of the dividend, and this is especially true where the dividend is a large or unusual one.

Judge Hand bases his conclusion upon the true ground, viz, that the assets which were represented by the Delaware stock were no longer the property of the New Jersey company. The soundness of his conclusion can be shown by a simple illustration.

Suppose the New Jersey company had declared, out of its surplus, a cash dividend of $58,854,200, or $200 a share, and the stockholders had used this in subscribing to a like amount at par of the stock of the Delaware company, and the Delaware company had then used the $58,854,200 in the purchase of the plant and other assets of the New Jersey company, would not the transaction be in substance the same and would there, in that event, be any doubt about the liability of the New Jersey stockholder to pay a tax upon such cash dividends? In that event he would have, as in the instant case, the stock of the Delaware company.

What matters it whether the Delaware stock, which was issued against the assets purchased from the New

Jersey company, was distributed as a dividend to the New Jersey stockholders, or the New Jersey stockholders first received the cash and then got the Delaware stock? In either event the New Jersey stockholder received cash or its equivalent, for he could sell his Delaware company stock for cash without diminishing his proportionate interest in the capital stock of the New Jersey corporation.

V.

THE AUTHORITIES.

It is an established principle that the ownership by one corporation of the stock of another corporation, or the ownership by the stockholders of one corporation of the stock of another corporation, does not destroy the distinct legal entity of the two corporations.

Pullman's Palace Car Co. v. *Missouri Pac. Co.*, 115 U. S. 587, 597.

Peterson v. *Chicago, R. I. & Pac. Ry. Co.*, 205 U. S. 364, 391.

Pittsburgh & Buffalo Co. v. *Duncan et al.*, 232 Fed. 584, 587.

In re Watertown Paper Co., 169 Fed. 252.

Walker, Coll'r., v. *Gulf and Interstate Ry. Co. of Texas*, 269 Fed. 885.

In cases involving taxation the courts have consistently refused to disregard the principle of corporate entity. As was said in *Eisner* v. *Macomber*, 252 U. S. 189, at page 214:

> * * * We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical

> fact but because it is only by recognizing such separateness that any dividend—even one paid in money or property—can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even when divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.

The decisions of the Supreme Court in *Southern Pacific Ry. Co.* v. *Lowe* (247 U. S. 330) and *Gulf Oil Corporation* v. *Lewellyn* (248 U. S. 71) are clearly distinguishable from the instant case.

In *Southern Pacific Ry. Co.* v. *Lowe*, the Southern Pacific Company prior to March 1, 1913, owned all of the stock of the Central Pacific Railway Company and "*was in the actual physical possession of the railroads and all other assets*" and "*in charge of its operations,*" and "*acted as cashier and banker of the entire system.*" The Central Pacific kept no bank account and if it needed money for additions or betterments or otherwise, the necessary funds were advanced by the Southern Pacific. In short, the Central Pacific was a mere name, and the court held that the Southern Pacific had the full ownership and control of the company

and its property and assets. The court expressly limited its opinion to the case before it, saying that it rested on "its very peculiar facts."

This case is distinguished in *Peabody* v. *Eisner* (247 U. S. 347), on page 349, as follows:

> * * * *Southern Pacific Co.* v. *Lowe*, has been reversed this day, ante 330, but only upon the ground that the Central Pacific Railway Company, which paid the dividend, and the Southern Pacific Company, which received it, were in substance identical corporations because of the *complete ownership* and control which the latter possessed over the former as stockholder and in other capacities, so that while the two companies were separate legal entities, yet in fact and for all practical purposes the former was but a part of the latter, acting merely as its agent and subject in all things to its direction and control; and for the further reason *that the funds represented by the dividend were in the actual possession and control of the Southern Pacific Company as well before as after the declaration of the dividend.*

See also the distinction made in *Lynch* v. *Hornby* (247 U. S. 339), on page 346.

In the *Gulf Oil Corporation case*, 248 U. S. 71, the Gulf Oil Company "was a holding company *owning all the stock* in the other corporations concerned excepting the qualifying shares held by directors. These companies with others *constituted a single enterprise.*"

There is little similarity between the facts in these cases and the facts in the instant case. The Delaware corporation does not own any, much less all of the, stock

in the New Jersey corporation, and while the New Jersey corporation *momentarily* owned all of the *issued* stock of the Delaware corporation, yet it made an immediate division of it, (1) reserving for its treasury the equivalent of its capital stock, (2) distributing to its bondholders and preferred stockholders sufficient stock to pay the one and retire the other, and (3) distributing the remainder of the stock among its individual stockholders. The Delaware corporation was organized for a definite and distinct purpose, and the New Jersey corporation likewise continued its existence for a definite and distinct purpose. It is plain that there was not a merger of the two, or that one was merely the reorganization of the other. Both corporations are still in existence, and each has its own distinct assets and liabilities.

The case of *Southern Pacific Company* v. *Lowe* would only be analogous and its doctrine applicable if the New Jersey corporation owned *all* the stock of the Delaware corporation, conducted *all* the operations of the business, had possesssion of *all* the funds, and plant, and simply declared a dividend payable solely to itself.

It is obvious that no such case is presented here. Each company has its own management, its own funds and property, conducts it own operations, declares its own dividends, and pays them to its own stockholders, who, if temporarily identical on October 1, 1915, ceased to be identical, as the stocks of each corporation were bought and sold on the market. The stock-

holders of the New Jersey corporation, therefore, received a dividend of stock in a new, distinct, and separate corporation.

VI.

PEABODY V. EISNER IS CONTROLLING.

Bearing in mind the difference in corporate entity between the New Jersey corporation and the Delaware corporation, and the fact that the property of the New Jersey corporation was sold for stock in the Delaware corporation, and that part of such stock was distributed to the stockholders of the New Jersey corporation as a dividend, the case of *Peabody* v. *Eisner* (247 U. S. 347), holding that where a corporation pays a dividend in the stock of *another* corporation such dividend is not a stock dividend but is a distribution in specie of a portion of the assets of the declaring corporation, is controlling.

In that case the Union Pacific Railroad, prior to March 1, 1913, and thereafter, had large holdings of the common and preferred stocks of the Baltimore & Ohio Railroad. On March 2, 1914, the Union Pacific declared a dividend payable in these stocks. In distinguishing the case of *Towne* v. *Eisner* (245 U. S. 418), the court said:

> It hardly is necessary to say that this case is not ruled by our decision in *Towne* v. *Eisner*, since the dividend of Baltimore & Ohio shares was not a stock dividend but a distribution *in specie* of a portion of the assets of the Union Pacific, and is to be governed for all present purposes by the same rule applicable to the

> distribution of a like value of money. It is controlled by *Lynch* v. *Hornby*, this day decided, *ante*, 339. (*Peabody* v. *Eisner*, 247 U. S. 347, 349–350.)

The principle laid down in *Peabody* v. *Eisner* (*supra*) was approved in *Eisner* v. *Macomber* in the following language:

> The Government's reliance upon the supposed analogy between a dividend of the corporation's own shares *and one made by distributing shares owned by it in the stock of another company*, calls for no comment beyond the statement that the latter distributes assets of the company among the shareholders while the former does not; and for no citation of authority except *Peabody* v. *Eisner*, 247 U. S. 347, 349–350. (*Eisner* v. *Macomber*, 252 U. S. 189, 215.)

The case of *Eisner* v. *Macomber* (252 U. S. 189) defines a stock dividend as one paid by a corporation *in its own stock*. As showing the nature of a stock dividend, the court says, at page 211:

> A "stock dividend" shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.

> The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment.

In referring to the case of *Towne* v. *Eisner* (245 U. S. 418, 426) the court, in the *Macomber case,* says:

> Notwithstanding the thoughtful discussion that the case received below we can not doubt that the dividend was capital as well for the purposes of the income-tax law as for distribution between tenant for life and remainderman. What was said by this court upon the latter question is equally true for the former: "A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. * * * The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones." *Gibbons* v. *Mahon,* 136 U. S. 549, 559, 560. In short, the corporation is no poorer

> and the stockholder is no richer than they were before. *Logan County* v. *United States*, 169 U. S. 255, 261. (*Eisner* v. *Macomber*, 252 U. S. 189, 202–203.)

The *Macomber case* thus establishes with finality the principle that the payment of a dividend *in the stock of another corporation* is not a stock dividend.

The Supreme Court in that case states the salient characteristics of a stock dividend to be:

1. That it takes nothing from the property of the declaring corporation, and adds nothing to the interests of the stockholders;

2. That the evidence representing their interest has merely been split up into a different number of shares.

Let us apply these tests to the instant case.

1. In the case at bar the New Jersey corporation is poorer to the extent of the dividend declared in the permanent severance ftom its assets of valuable interest-bearing securities, which were thus transferred to the stockholders of the New Jersey corporation as individual owners and they in turn are richer in their power to dispose of these valuable securities as their own property.

(2) Applying the second test, something more has happened to the New Jersey stockholder than the mere duplication of his certificates of its stock. Without losing his proportionate interest in the capital stock of the New Jersey corporation, he has acquired valuable securities, being shares of another corporation, which, if he will, he can immediately con-

vert into cash. It is true that the assets of the New Jersey corporation have been diminished, and that therefore his New Jersey stock no longer has the same value, but this is always the case where a corporation divides its profits by declaration of dividends, whether in cash or specie. The unescapable fact is that the New Jersey stockholder thus received a portion of the great surplus of undivided profits, to which he had doubtless been looking with longing eyes as they rolled up with unprecedented rapidity. The melon of a vast surplus had been cut. It matters not whether the stockholder received it in tangible property, valuable securities, or cash. He had reaped the reward of his waiting. Without diminishing his proportionate interest in the New Jersey company, he could sell the stock in the Delaware corporation, which he received as a dividend, for the sum of $347.50 per share. In this way, the plaintiff, having awaited the cutting of an exceptionally juicy melon, received upon his holding of 250 shares, *which he still retained*, the equivalent in cash of $173,750, and I confess my inability to see why he should not pay his income tax as well as any other stockholder, who receives a dividend payable in cash, or the equivalent thereof.

VII.

The dividend in the present case was not a liquidation dividend.

The admitted facts in this case show that the New Jersey corporation retained sufficient assets represented by the debenture stock of the Delaware corporation

to equal the par value of the New Jersey corporation's outstanding common stock. There was no retirement of the capital stock of the New Jersey corporation. The corporation continued to function as a corporation, receiving income and paying dividends. A liquidating dividend necessitates a retirement of stock outstanding and the Court of Claims has found that the New Jersey corporation has not retired its common stock and has an equivalent amount in interest-bearing assets.

> The New Jersey corporation, after the distribution of the stock of the Delaware corporation, continued as a going concern and is still in existence * * * and is not in process of liquidation. (Finding X, Rec. p. 20.)

The case of *Lynch* v. *Turrish* (247 U. S. 221), therefore, has no application to the facts in the present case. As was said by the court in that case:

> And in determining the application of the statute to Turrish we must keep in mind that on the admitted facts the distribution received by him from the Payette Company manifestly was a single and final dividend *in liquidation of the entire assets and business* of the company, a return to him of the value of his stock upon the surrender of his entire interest in the company, and at a price that represented its intrinsic value at and before March 1, 1913, when the act took effect. (Italics ours.) (*Lynch* v. *Turrish*, 247 U. S. 221, 226.)

The limitations of the *Turrish case* are clearly brought out in the case of *Lynch* v. *Hornby* (247 U. S.

339), in which it was held that a dividend, even though extraordinary in amount and derived from a surplus of corporate assets existing before March 1, 1913, was nevertheless taxable, the court saying:

> The case was tried in the District Court and argued in the Circuit Court of Appeals, together with *Lynch* v. *Turrish* (236 Fed. Rep. 653), and was treated as presenting substantially the same question upon the merits. In our opinion it is distinguishable from the Turrish case, where the distribution in question was a single and final dividend received by Turrish from the Payette Company in liquidation of the entire assets and business of the company and a return to him of the value of his stock upon the surrender of his entire interest in the company, at a price that represented its intrinsic value at and before March 1, 1913, when the Income Tax Act took effect.
>
> In the present case there was no winding up or liquidation of the Cloquet Lumber Company, nor any surrender of Hornby's stock. He was but one of many stockholders, and had but the ordinary stockholder's interest in the capital and surplus of the company, that is, a right to have them devoted to the proper business of the corporation and to receive from the current earnings or accumulated surplus such dividends as the directors in their discretion might declare. *Gibbons* v. *Mahon*, 136 U. S. 549, 557 * * *. (*Lynch* v. *Hornby*, 247 U. S. 339, 341.)

In the *Hornby case* the court distinguishes the cases of *Lynch* v. *Turrish* and *Southern Pacific* v. *Lowe*, as follows:

> Of course we are dealing here with the ordinary stockholder receiving dividends declared in the ordinary way of business. *Lynch* v. *Turrish* and *Southern Pacific Co.* v. *Lowe*, rest upon their special facts and are plainly distinguishable. (P. 346.)

VIII.

DIMINUTION OF MARKET VALUE UNIMPORTANT.

The Court of Claims was, I respectfully submit, led astray in this case by the seeming hardship of the accidental circumstance that the value of the plaintiff's New Jersey stock before the payment of the dividend was precisely the same as the value of his New Jersey and Delaware holdings after the payment of the dividend. The court says:

> The figures indisputably demonstrate that by the transaction the plaintiff did not gain or lose a penny.

The Court of Claims adds:

> As a matter of fact if the position of the defendants is to be sustained the plaintiff herein instead of receiving an income from the transaction loses $5,657.97, which he must pay from gains derived from a source other than the one in controversy, or out of his original investment.

Impressed by this the Court of Claims argues:

> It seems incredible that Congress intended to tax as income a business transaction which admittedly produced no gain, no profit, and hence no income. If any income had accrued to the plaintiff by reason of the sale and exchange made it would doubtless be taxable.

This court has shown the unsoundness of this reasoning when it answered the same argument in *Lynch* v. *Hornby, supra*, as follows:

> We do not overlook the fact that every dividend distribution diminishes by just so much the assets of the corporation and, in a theoretical sense, reduces the intrinsic value of the stock. But at the same time it demonstrates the capacity of the corporation to pay dividends, holds out a promise of further dividends in the future, and quite probably increases the market value of the shares. In our opinion Congress laid hold of dividends paid in the ordinary course as *de facto* income of the stockholder, *without regard to the ultimate effect upon the corporation resulting from their payment.*

Had the fallacious argument of the Court of Claims as to the net pecuniary result to the stockholder of the declaration of the dividend been of any importance the Supreme Court would have decided the case of *Peabody* v. *Eisner*, 247 U. S. 347, differently, for in that case the moment the Union Pacific Railroad Company distributed the Baltimore and Ohio stock the shares of the former dropped in the market by

the precise amount of the value of the latter, and thus the Union Pacific stockholder found himself no richer and no poorer by reason of such payment. Every taxpayer, whose income is from stock investments, generally finds himself after the payment of his dividend momentarily no better off, for the new valuation of his stock is the old amount less the dividend. The theory upon which the Court of Claims ruled the instant case would mean that the Government of the United States has erroneously collected hundreds of millions of dollars from stockholders who paid taxes on dividends and who by reason of temporary fluctuation on the stock exchange found themselves after the receipt of the dividend no richer and no poorer.

Every dividend, except a stock dividend, "diminishes by just so much the assets of a corporation." Fluctuation in market value is not the criterion which determines whether income has been derived from capital, but the segregation of corporate assets, which before segregation represented only an inchoate right of the stockholder, does determine whether income has been received. (See *Eisner* v. *Macomber*, p. 208).

The circumstances, under which surplus is severed and thereby something is lost to the company and something is gained by the stockholder, were stated by this court as follows:

> * * * If profits have been made and not divided they create additional bookkeeping liabilities under the head of "profit and

> loss," "undivided profits," "surplus account," or the like. None of these, however, gives to the stockholders as a body, much less to any one of them, either a claim against the going concern for any particular sum of money, or a right to any particular portion of the assets or any share in them unless or until the directors conclude that dividends shall be made and a part of the company's assets segregated from the common fund for the purpose. The dividend normally is payable in money, under exceptional circumstances in some other divisible property; and when so paid, then only (excluding, of course, a possible advantageous sale of his stock or winding up of the company) does the stockholder realize a profit or gain which he owes his separate property, and thus derive income from the capital that he or his predecessor has invested. (*Eisner* v. *Macomber*, 252 U. S. 189, 209.)

The dividend received by the stockholders of the New Jersey corporation represented such a segregation from the surplus profits of the New Jersey corporation, and the realization thereon by the stockholder was income. The dividend came *ab extra* and constituted "a gain derived from capital"—"income derived from any source whatever."

It is immaterial whether the property sold by the New Jersey corporation to the Delaware corporation was acquired prior to March 1, 1913, or after March 1, 1913. This principle was settled by the case of *Lynch* v. *Hornby* (247 U. S. 339).

IX.

THE ARGUMENT FROM HARDSHIP.

The argument, which evidently most deeply impressed the Court of Claims, and which probably will be pressed upon this court with the greatest insistence, is the alleged hardship upon the stockholder of the New Jersey company, who, having on September 30, 1915, 250 shares of stock of that corporation, which were valued at $795 per share, found, after he had received his dividend in the Delaware stock, that his investment had shrunk from $795 per share to $100 per share. It will be claimed that this demonstrates that it was, in fact, a tax upon the capital investment of the stockholder. It will probably be argued that to pay the income tax upon the stockholder's dividend results in an actual diminution of his so-called capital investment.

In reply, I submit that we are dealing with the case of a distribution of profits which were unprecedented in size, and that the case in principle would not differ whether the dividend was, as in this case, disproportionate to the par value of the stock and the case where a dividend was, as is usual with most dividends, small in proportion to such par value.

"Hard cases make bad law," and this court should be very slow in asserting a principle with respect to a dividend of unusual size, which would necessarily be applicable to a very much smaller dividend. *The hardship, however, is more apparent than real.*

The record does not disclose what the New Jersey stock cost the plaintiff. Let us assume the most

favorable situation with respect to the plaintiff's claim by assuming that Phellis had paid, shortly before the declaration of the dividend, the full market price of $795 per share. In that event, it is undoubtedly true that with the declaration of this dividend his stock had immediately shrunk to $100 per share. Nevertheless, it was within his power, and for aught that the record discloses he exercised that power, to sell his stock, after the stock sold ex-dividend, for the new market value of $100.

In that event, he did not suffer any hardship whatever, for in making up his income account on the debit side he would account for his share of the accumulated profits by admitting a receipt of $695 in value from dividends, and on the credit side he would get a credit for the precise amount of such shrinkage in the value of his stock. Thus he would pay no tax at all. How, then, was he injured?

As the Phellis case will necessarily be applicable to many other stockholders of the New Jersey corporation, it is inconceivable that the very astute business men, who thus were able by the exigencies of the war to roll up this prodigious snowball of profits, did not, if they had paid a sum for the stock which represented its original value plus these great profits, sell their stock to establish a loss which would counterbalance their particular slice of this very juicy melon.

Let us suppose, on the other hand, that Phellis had been an original purchaser of the stock at or near par, or let us take the price of the stock as it was on March 1, 1913, when it was selling at about $130 a

share.[1] Between the period of his original investment at $100 a share, or between the period when his stock was valued for taxation purposes at $130 a share, he had been the fortunate possessor of shares of stock which, through the amassing of war profits, had earned approximately six times the value of his stock. Unquestionably he had thus profited by this great accumulation of profits. It is true that until the company declared a dividend he could not be taxed upon his share of this vast accumulation of profits, even though his stock mounted by leaps and bounds in a period of less than two years from $100 a share, or, as of March 1, 1913, $130 per share, to $795 a share. If he had sold his stock prior to the declaration of this large dividend, he would unquestionably have been obliged to account and pay a tax upon the great appreciation in the value of the stock due to these great profits. When, however, he preferred to hold the stock to await the "cutting of the melon," and when the melon was cut and he thus received, as a dividend, his slice of these accumulated profits, amounting to $695 per share, *what hardship is there in his being asked to pay a tax upon such war profits?*

X.

TOWNE V. EISNER, DISTINGUISHED.

In commenting upon the *Towne case* in *Eisner* v. *Macomber*, this court said:

[1] The record does not disclose what the value of the stock was on March 1, 1913. I have taken the figure from stock exchange statistics. If this is disputed, the figure can be taken not as the statement of a fact but as an illustration of possible value at that time.

> * * * In *Peabody* v. *Eisner* (pp. 349–350) we observed that the decision of the District Court in *Towne* v. *Eisner* had been reversed "only upon the ground that it related to a stock dividend which in fact took nothing from the property of the corporation and added nothing to the interest of the shareholder, but merely changed the evidence which represented that interest"; and we distinguished the *Peabody case* from the *Towne case* upon the ground that "the dividend of Baltimore & Ohio shares was not a stock dividend but a distribution *in specie* of a portion of the assets of the Union Pacific."

If the New Jersey corporation's property had been sold for cash and the amount over and above that represented by its capital stock distributed as a cash dividend, taxable income would undoubtedly have been received by the stockholders of the New Jersey corporation. *Lynch* v. *Hornby, supra.*

This court has recently recognized the doctrine that a sale of corporate assets for stock of another corporation, when such stock has a wide and general market, is the equivalent of a sale for cash. (*Geddes* v. *Anaconda Mining Company*, 254 U. S. 590, 598.)

In that case, this court said:

> It would be a reproach to the law to invalidate a sale otherwise valid because not made for money, when it is made for stock which a stockholder receiving it may at once, in the New York or other general market, convert into an adequate cash consideration for what his holdings were in the corporate property.

Therefore, in the instant case where the assets of the New Jersey corporation were sold for stock of the Delaware corporation, and such stock had an ascertained cash value, taxable income was received by the stockholders of the New Jersey corporation upon the declaration and payment to them of the dividend in stock of the Delaware corporation. They could immediately convert it into cash. Thus they received in the equivalent of cash their share of a huge surplus of war profits. Why should they not pay an income tax thereon?

XI.

WAR PROFITS.

The plaintiff below, in his petition in the Court of Claims, appended an exhibit wherein it is stated that included in the corporate assets of the New Jersey company was "a large surplus accumulated practically entirely after the outbreak of the European war." (Rec., p. 7.) Even if this had not suggested to the court the nature of these profits thus divided as dividends, this court, having in mind the history of the times, would not be oblivious to the fact that in this case it has under consideration a tax upon a dividend arising from war profits.

This is not mentioned to suggest a prejudice against this form of corporate earnings, for, if the du Pont Powder Company made great profits by reason of the terrible exigencies of the war, they likewise rendered an inestimable service, for it may be true that the World War would have been

lost had it not been for the du Pont Powder Company, the granaries of the Northwest, and the steel mills of Bethlehem and Pittsburgh.

The fact is only mentioned because in this and other cases to be argued herewith the suggestion has been made that this dividend, because it was abnormal in size and not in its nature "recurrent," should in some way on that account escape taxation.

Freely conceding that the du Pont Powder Company was fully entitled to all it made out of the war, it still remains that its shareholders should be willing, as all other citizens, to pay a tax upon their dividends.

The plaintiff and all his fellow stockholders had received in valuable securities, immediately convertible into cash, their share of these huge war profits, and it would seem unconscionable to permit them, merely because their dividends were in specie and not in cash, to escape their fair share of the burdens of taxation.

XII.

IMPORTANCE OF DECISION.

This case involves many millions of dollars to the Treasury of the United States in its application to the stockholders of this and many other corporations, but the *principle* involved, as bearing upon the honest collection of taxes upon dividends, is even more important.

I have not impeached the good faith of the du Pont Company transaction, or suggested that the transaction under consideration was a mere method of evading taxes, for there is nothing in the record to justify such inference and I do not believe it. The

good faith of the management of the du Pont Powder Company is therefore conceded.

Nevertheless, the fact remains that, if their contention should prevail, an easy method has been provided to enable corporations to distribute their surplus among their stockholders in the equivalent of cash without the stockholders paying their fair share of the burdens of taxation. A corporation need only transfer its surplus to another corporation and take in return its stock and then distribute it among its stockholders.

For example, the Standard Oil Company of New Jersey could transfer the whole or part of its huge surplus to the Standard Oil Company of California, receive a new issue of the latter company's stock and distribute it as a dividend among the former company's stockholders, and they would be in the happy position of having securities that are as good as Government bonds without the necessity of paying any taxes and without diminishing their stockholding interest in the New Jersey company.

> Can such things be,
> And overcome us like a summer's cloud,
> Without our special wonder?

Respectfully submitted.

JAMES M. BECK,
Solicitor General.

CARL A. MAPES,
Solicitor of Internal Revenue.

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ANDREW J. ALDRIDGE,
Special Attorneys, Internal Revenue.

SEPTEMBER, 1921.

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IN THE

Supeme Court of the United States

OCTOBER TERM, 1921.

No. 260.

THE UNITED STATES, *Appellant,*

vs.

C. W. PHELLIS, *Appellee.*

BRIEF FOR APPELLEE.

The Commissioner of Internal Revenue on December 31, 1919, assessed Appellee with additional income tax "for the year 1915 because of the receipt by him of said stock (E. I. duPont de Nemours and Company Stock, hereinafter called the Delaware Company), said assessment being in the sum of $5,657.97" (Finding XIII, R. 20).

The stock referred to was received by Appelee on October 1, 1915, under the circumstances hereinafter set forth, and the Appellee having complied with all requirements of law, and having paid the assessment under protest brought his suit in the Court of Claims to recover the amount so paid.

On trial the Court of Claims entered judgment (R. 23) in favor of Appellee (Claimant below) and the United States appealed to this Court.

STATEMENT OF FACTS.

The Court of Claims found the following facts:

1. Appellee, a citizen of the United States, on and prior to September 30, 1915, was the owner of 250 shares of the common stock of E. I. duPont de Nemours Powder Company, a corporation of the State of New Jersey, and hereinafter called the "New Jersey Company" (Findings I and II, R. 8 and 9).

This Company was and had been for a number of years engaged in the production, manufacture and sale of powder, dynamite, and other explosives, with plants located in the State of Delaware and other States, and in September, 1915, in addition to its preferred stock then outstanding, and its bonds, common stock of the company, of the par value of $100 per share, had been issued, amounting to $29,427,100 (Finding III, R. 9, 10, 11).

2. On the 19th of August, 1915 (Finding III, R. 9) a letter was addressed to the stockholders of the New Jersey Company by its President, stating:

> "The business of the Company has greatly increased in volume, so that it has become necessary to *materially increase our capital to provide for proper and economical operation.* Your officers have given the problem long and serious consideration, *with the result that the Board of Directors have approved a plan for the re-adjustment of its financial affairs,* which may be briefly summarized, as follows," etc. (Italics ours.)

The purpose, as approved by the "Board of Directors" and recommended by the President, was "to materially increase our capital to provide for proper and economic operation," and the great war, referred to by the Solicitor General, then raging, the President and the Directors apparently desired to strengthen the Company, in order that it might discharge its full duty. There was no purpose to then transfer "gains or profits and income" to the stockholders, but as hereinafter shown, to turn all of the assets of the Company including any surplus and cash into *fixed capital,* merely providing for the stockholders' certificates as evidence of an undivided, unsegregated and identically proportionate interest in such assets. The purpose was to fix the assets of all kinds as capital for the purposes of the business and to prevent their being taken out of the treasury of the Company, by distribution to stockholders.

The plan was then set forth in the letter aforesaid, in detail (Finding III, R. 9) and contemplated the organization of a new Company under the laws of the State of Delaware (bringing the business back home) to be known as the E. I. duPont de Nemours and Company (hereinafter referred to as the Delaware Company) and that the New Jersey Company should transfer to the Delaware Company *all* "its property, assets, rights and privileges including the good will of the business," the transfer to be "as an entirety and as a going concern" (Finding IV, R. 13, 14); the Delaware Company "to assume all the liabilities" of the New Jersey Company, and after providing for the exchange by stockholders of the preferred stock of the New Jersey Company, and certain of its bonds for debenture stock of the Delaware Company, common stock of the Delaware Company (a total of $58,854,200), was to be issued to the New Jersey

Company of the par value of $100 per share, and in an amount double that of the outstanding common stock of the New Jersey Company.

The plan further contemplated that each stockholder of the New Jersey Company should continue to hold his common stock, and in addition thereto receive for each share of the common stock held by him in the New Jersey Company two shares of the common stock of the Delaware Company.

The stockholders of the New Jersey Company assented to the aforesaid "plan for readjusting the financial affairs of that Company" in order to "materially increase our capital to provide for proper and economical operation," and to "the transfer of all of the property, assets, rights and privileges" of the New Jersey Company "as an entirety to E. I. duPont de Nemours and Company," of Delaware (Finding III, R. 11, 12).

3. As the result of the proposal and assent of the stockholders, the plan set forth in the letter of August 19, 1915, was carried into an agreement (Finding IV, R. 13) duly authorized by the Boards of Directors of the New Jersey Company and the Delaware Company, reciting that the New Jersey Company, "with the written assent of the holders of more than two-thirds of the capital stock * * * has offered to sell and convey" to the Delaware Company, the real, personal and mixed property of the New Jersey Company *"as an entirety and as a going concern"* for $120,000,000, payable in cash ($1,484,000) and in the capital stock of the Delaware Company, and also reciting that the Board of Directors of the New Jersey Company had ascertained that the "real, personal and mixed property aforesaid are of the

fair value of $120,000,000." The effect of this was to convert all of the assets *into fixed capital,* with stock certificates issued against the same, and to the value thereof.

The New Jersey Company then agreed to transfer all of its property, "real, personal and mixed," all its cash, accounts, and "all the vendor's property, assets, rights, and privileges, including the good will of the business" (R. 14). The consideration therefor was $1,484,100 cash (which was never really paid, but was retained from the cash then held in the treasury of the New Jersey Company) and $58,854,100 in common stock and $59,661,700 in the debenture stock of the Delaware Company (Finding V, R. 19).

The Delaware Company, as a part of the consideration, agreed "to assume and discharge all the liabilities, debts and obligations, contractual or otherwise, of any kind, nature and description due or to become due" of the New Jersey Company, except capital stock liability and the funded debt which was to be replaced by the debenture stock received from the Delaware Company (R. 15).

4. The transfer of the complete property and assets, cash and good will of the New Jersey Company "as an entirety and as a going concern" was made to the Delaware Company on October 1, 1915, by Bill of Sale (Finding V, R. 16, 17, 18). The Delaware Company delivered to the New Jersey Company 588,342 shares of its common stock of the par value of $100 per share, and 596,617 shares of its debenture stock of the par value of $100, and the New Jersey Company retained $1,484,-100 of the cash which was in its treasury, with which to

redeem its outstanding 5 per cent bonds referred to in the letter of August 19, 1915, and the agreement aforesaid (R. 18, 19).

On October 1, 1915, the New Jersey Company held (Finding VI, R. 19):

a. Cash $1,484,100, with which to pay its outstanding 5 per cent bonds.

b. Debenture stock of the Delaware Company to exchange for the outstanding preferred stock of the New Jersey Company, to wit, $16,068,801.34.

c. Debenture stock of the Delaware Company to exchange for the outstanding 4½ per cent bonds of the New Jersey Company, to wit, $14,166,000.

d. Debenture stock of the Delaware Company in an amount equal to the outstanding par value of the common stock of the New Jersey Company, to wit, $29,427,100.

e. Two shares of the common stock of the Delaware Company for each share of the common stock of the New Jersey Company then outstanding.

Thus all of the assets of the business—capital, surplus, cash, good will and everything owned by the New Jersey Company—were removed from the *possibility* of distribution to the stockholders, and became capital investment for use in the same business operated and conducted thereafter by the same stockholders and officers, under a Delaware charter.

5. As of October 1, 1915 (Finding VII, R. 19), the New Jersey Company distributed to the holder of each share of its common stock two shares of the common

stock of the Delaware Company, and the original holders of the common stock of the New Jersey Company continued each to hold his original shares of common stock in the latter Company.

6. As of October 1, 1915, the Delaware Company took over all of the assets of the New Jersey Company (excepting the cash of $1,484,100), and Appellee received 500 shares of the common stock of the Delaware Company and continued to hold his 250 shares of the common stock of the New Jersey Company (Finding VII, R. 19).

7. The personnel of the stockholders and officers of the two corporations was on October 1, 1915, identical. The *"holders of common stock of said corporations had each the same proportionate stock holding in both corporations"* (Finding VIII, R. 9).

8. The New Jersey Company has held the debenture stock of the Delaware Company to the amount of $29,427,100.00, and has received 6 per cent per annum on said stock which has been paid to the preferred and common stockholders of the New Jersey Company, and which has, of course, been returned as income by said stockholders, and income tax paid thereon (Finding IX, R. 20).

9. The New Jersey Company since October 1, 1915, "has done no business" except (Finding X, R. 20):

a. Collection of dividends on debenture stock of Delaware Company, and payment thereof to its own stockholders.

b. Redemption of its outstanding bonds and exchange of Delaware Company debenture stock for its preferred stock.

c. Holding Delaware Company debenture stock to an amount equal to the outstanding common stock of the New Jersey Company.

The New Jersey Company is not in process of liquidation.

10. The fair market value of the common stock of the New Jersey Company, on September 30, 1915, was $795.00 per share, and the fair market value of one share of the New Jersey Company common stock on October 1, 1915, was $100 per share, and of each share of the Delaware Company common stock $347.50 per share; therefore, the stock held by each stockholder in both companies was worth exactly the same on October 1, 1915, as the common stock of the New Jersey Company held by him was worth on September 30, 1915 (Finding XI, R. 20).

11. The Commissioner of Internal Revenue held that each stockholder of the New Jersey Company received income on October 1, 1915, in an amount equal to the number of shares of the common stock of the Delaware Company received by him, on that date, multiplied by $347.50, and the Appellee was assessed on that basis.*

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*While some few shares of the New Jersey Company stock sold in the market for $795 per share. and Delaware Company stock for $347.50 per share, no considerable part of this stock could have been sold at such figures, and this was the only evidence of valuation used by the Government in the assessment, and was "an unsafe criterion." (Eisner vs. Macomber, 252 U. S., at p. 215.) The book value of the stock was entirely disregarded, and this showed the Delaware Company stock worth not more than par.

If the assessment had been based upon par, as was attempted in Towne vs. Eisner, plaintiff would have been charged with income of only $50,000 instead of being charged with income of $173,750, as he is.

12. The Appellee having paid the assessment under protest brought this suit to recover the amount paid.

CONCLUSION OF THE COURT OF CLAIMS.

The Court of Claims held, "upon the foregoing Findings of Fact the Court decides that plaintiff is entitled to recover the sum of $5,657.97" (R. 21), and judgment was entered therefor in favor of the Appellee (Plaintiff below).

The Court of Claims based its conclusion and judgment on the ground that there was "no net income arising or accruing" to the Appellee on the transaction, and that no "gains or profits and income" had been "derived" by the Appellee.

The Court said (R. 22):

> "As a matter of fact, if the position of the defendants is to be sustained, the Plaintiff herein instead of receiving an income from the transaction loses $5,657.97, which he must pay from gains derived from a source other than the one in controversy, or out of his original investment."

Further:

> "We think the whole transaction is to be regarded as merely a financial reorganization of the business of the company, and that this view is justified by the power and duty of the court to look through the form of the transaction to its substance."

Further:

> "It seems incredible that Congress intended to tax as income a business transaction which ad-

mittedly produced no gain, no profit, and hence no income. If any income had accrued to the plaintiff by reason of the sale and exchange it would doubtless be taxable.

ARGUMENT.

In considering how this transaction is to be understood and construed, involving as it does the transfer of the assets of the New Jersey Company "as an entirety and as a going concern" to the Delaware Company, and the assumption by the latter company of the liabilities of the former, we may refer for guidance to the rule laid down by this court in the case of Eisner vs. Macomber, 252 U. S., 189, at page 213, as follows:

> "We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right in order to ascertain whether he has received income taxable by Congress without apportionment."

We urge that "having regard to the very truth of the matter, to substance and not to form," the stockholder of the Delaware Company "has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment." Eisner vs. Macomber, 252 U. S., 189, at p. 211.

THE LAW UNDER WHICH THE ASSESSMENT WAS MADE.

The Sixteenth Amendment to the Constitution of the United States provides:

> "The Congress shall have power to lay and collect taxes on *incomes* from whatever source *de-*

> *rived* without apportionment among the several states, and without regard to any census or enumeration." (Italics ours.)

Under this provision of the Constitution no tax could be assessed without apportionment unless the subject taxed was "income," which must have been "derived" by the party assessed.

Under authority given by the Sixteenth Amendment, Congress passed the Act of October 3, 1913, under which this assessment was made, which provides (Section A, Sub-Division 1) for a levy or assessment:

> "*Annually* upon the entire *net income arising* or *accruing* from all sources in the preceding calendar year to every citizen of the United States." (Italics ours.)

The Act (Section B) defines the "net income of a taxable person" as

> "gains, profits and income derived from (1) salaries, wages or compensation for personal service of whatever kind and in whatever form paid, or (2) from professions, vocations, businesses, trade, commerce, or sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property; (3) also from interest, rent, dividends, securities or the transaction of any lawful business carried on for gain or profit, or (4) gains or profits and income derived from any source whatever including the income from but not the value of property acquired by gift, bequest, devise or descent."

In order therefore to justify the assessment against the Appellee, the 500 shares of common stock of the Dela-

ware Company received by him on October 1, 1915, must have been "income" and the same must have been "derived" by the Appellee, in order to meet the provisions of the Sixteenth Amendment to the Constitution. And, further, the 500 shares must have come within the definition of "net income," provided by Section B of the Act of October 3, 1913, and the share of stock must appear to have been "gains or profits and income derived" by the Appellee from the transaction referred to.

Unless the 500 shares of common stock of the Delaware Company received by the Appellee come within the Sixteenth Amendment, no power existed in Congress to tax the same as income and unless the definition in the Act of October 3rd, 1913, fully covers the 500 shares of stock, the Commissioner had no power to make the assessment.

As was said by the District Court in the case of Towne vs. Eisner, 242 Fed., 702, at page 704, quoted with approval by the Supreme Court in Eisner vs. Macomber, 252 U. S., 189, at p. 202:

> "It is manifest that the stock dividend in question cannot be reached by the Income Tax Act, and could not even though Congress expressly declared it to be taxable as income, *unless it is in fact income.*" (Italics ours.)

In view of the foregoing, we maintain the following propositions:

I.

THE COMMON STOCK OF THE DELAWARE COMPANY RECEIVED BY APPELLEE ON OCTOBER 1, 1915, WAS NOT "INCOME ARISING OR

ACCRUING TO HIM" NOR WAS IT "GAIN OR PROFIT DERIVED BY HIM," BUT THE STOCK WAS SIMPLY THE EVIDENCE OF HIS PRO RATA INTEREST IN ASSETS OF THE COMPANY WHICH IT WAS DETERMINED TO RETAIN IN THE BUSINESS, IN INCREASING THE CAPITAL, UPON "A FINANCIAL REORGANIZATION OF THE BUSINESS," AND WAS NOT ASSESSABLE UNDER THE ACT OF OCTOBER 3, 1913.

The Court of Claims sustained this proposition and said (R. 22):

> "The defendant contends that the New Jersey and Delaware corporations must be regarded as 'separate and distinct legal entities' and that the case is within the rule of Peabody vs. Eisner, 247 U. S., 347. We think the transaction is to be regarded *as merely a financial reorganization of the business of the company*, and that this view is justified by the power and duty of the court to look through the form of the transaction to its substance." (Italics ours.)

The purpose of the transaction is shown by the letter of August 19, 1915 (R. 9), and it was proposed because it was "necessary to materially increase our capital to provide for proper and economic operation." The plan proposed was for "the readjustment of its financial affairs," and it is evident that there was no purpose in the Board of Directors to distribute any part of the assets of the New Jersey Company to its stockholders, but the purpose was to *fix and retain* all of the assets, cash and good will in an operating corporation, *as capital*, and to prevent the distribution thereof to the stockholders, issuing to the stockholders, however, additional

certificates as evidence of the same proportionate interests in exactly the same assets; and the plan contemplated the continued operation of the business "as an entirety," and under a new charter, "as a going concern."

The Board of Directors of the New Jersey Company ascertained that the assets of that Company were of "the fair value" of $120,000,000, and the purpose was to use all of these assets as a capital investment to carry on the *increasing business* of the Company, not to *distribute* any part thereof to the stockholders, but to *prevent* any distribution and to issue to the stockholders additional evidence of their pro rata interest in these same assets.

If upon a valuation of its assets the New Jersey Company had determined that all of the $120,000,000 assets were to be retained as capital, and had issued to the stockholders pro rata common stock based upon this valuation, there could be no contention properly made that the stockholder in receiving such additional common stock had received income, gain or profit thereby. This is admitted *by the* Government in its brief, p. 10.

The Government contends, however, that the fact of incorporation of the Delaware Company and that its common stock is issued to the stockholders of the New Jersey Company renders them liable. There is in substance no difference between an issue of common stock as evidence of pro rata interest in the same assets and business whether issued by the New Jersey Company or the Delaware Company. It is only a question of form. Before the transaction the stockholder's interest was represented by one certificate, afterwards by three, and his *proportionate interest* was the *same* in the *undivided assets* as found by the court below (Finding III, R. 19).

In the case of Gibbons vs. Mahon, 136 U. S., 549, this Court discusses the question of whether a stock dividend is income and payable to a life tenant, and at page 558 says:

> "Money earned by a corporation remains the property of the corporation and does not become the property of the stockholders unless and until it is distributed among them by the corporation. The corporation may treat it and deal with it either as profits of its business or as an addition to its capital. Acting in good faith and for the best interests of all concerned, the corporation may distribute its earnings at once to its stockholders as income; or it may reserve part of the earnings of a prosperous year to make up for 'possible' lack of profits in future years; *or it may retain portions of its earnings and allow them to accumulate, and then invest them in its own works and plant so as to secure an increase of the permanent value of its property.*" (Italics ours.)

So it will be observed that the Court indicates that there are three ways that a corporation may deal with its capital and earnings.

The Court then says, page 558:

> "Reserved and accumulated earnings, so long as they are held and invested by the corporation, being part of its corporate property, it follows that the interest therein represented by each share, is capital and not income, of that share, as between the tenant for life and the remainderman, legal or equitable, thereof."

The third way of dealing with the assets of a corporation, that is, "to retain portions of its earnings and allow them to accumulate and then invest them in its own works

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or plant, so as to secure an increase of the permanent value of its property" is the method which was adopted in the present case, and speaking of that way, the Court said, page 559:

> "Therefore, when a distribution of earnings is made by a corporation among its stockholders, the question whether such distribution is an apportionment of additional stock representing capital or a division of profits and income, depends upon the substance and intent of the action of the corporation, as manifested by its vote or resolution; and ordinarily a dividend *declared in stock is to be deemed capital*, and a dividend in money is to be deemed an income of each share." (Italics ours.)

The Court further held:

> "A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. After such a dividend, as before, the corporation has the title in all of the corporate property; the aggregate interests therein of all the stockholders are represented by the whole number of shares; and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of new ones."

The above quotations are applicable to the facts of this case and nothing could more accurately set forth the situation of Appellee, after receiving the Delaware Company common stock.

In the case of Eisner vs. Macomber, 252 U. S., 189, we have the last definition by this Court of the word "income" as used in the Sixteenth Amendment to the Constitution and in the Tax Act.

At page 207 this Court adopts the definition of income as "the gain derived from capital, from labor, or from both combined," adding thereto, however, "profit gained through a sale or conversion of capital assets." In discussing this definition, the Court said, page 207:

> "Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. 'Derived-from-capital'; 'the gain-derived-from-capital,' etc. Here we have the essential matter; not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, *severed from the capital* however invested or employed, and *coming in, being 'derived,'* that is, *received or drawn by* the recipient (the taxpayer) for his separate use, benefit and disposal; that is income derived from property. Nothing else answers the description." (Italics ours.)

Again the Court said at page 210:

> "Thus the surplus may increase until it equals or even exceeds the par value of the outstanding capital stock. This may be adjusted upon the books in the mode adopted in the case at bar—by declaring a 'stock dividend.' This, however, is

no more than a book adjustment, in essence not a dividend but rather the opposite; no part of the assets of the company *is separated* from the common fund, nothing distributed except *paper certificates* that *evidence an* antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company, but profits *so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution.*" (Italics ours.)

Again the Court said at page 213:

> "Thus, the Government contends that the tax 'is levied on income derived from corporate earnings,' when in truth the stockholder has 'derived' nothing except *paper certificates* which, so far as they have any effect, *deny him present participation* in such earnings. It contends that the tax may be laid when earnings 'are received by the stockholder,' whereas he has received none; that the profits are 'distributed by means of a stock dividend,' although a stock dividend distributes no profits; that under the Act of 1916 'the tax is on the stockholder's share in corporate earnings,' when in truth a stockholder has no such share, and receives none in a stock dividend; that 'the profits are segregated from his former capital, and he has a separate certificate representing his invested profits or gains,' *whereas there has been no segregation of profits,* nor has he any separate certificate representing a personal gain, since *the certificates,* new and old, are alike in what they represent—*a capital interest in the entire concerns of the corporation.*" (Italics ours.)

All of the foregoing quotations from the opinion of this Court are applicable to the facts in this case.

On the 30th day of September, 1915, a stockholder of the New Jersey Company, having one share, held a cer-

tificate which he could sell in the open market for $795.00 per share. This value did not arise or accrue in the preceding calendar year, but was the accumulated value based upon the company's assets. By the "financial reorganization of the business" of the company under which its properties, cash, good will and all its assets were transferred to a new operating company, the same stockholder held on the 1st day of October, 1915, three shares of stock represented by two certificates based upon exactly the same assets, undistributed, upon which his one share of stock in the New Jersey Company was based. There had been "no segregation of profits," there was no "certificate representing a personal gain" to the Appellee, "since the certificates new and old are alike in what they represent—a capital interest in the entire concerns of the corporation." The three shares of stock were worth $795.00, exactly what his one share in the New Jersey Company was worth on September 30, and we submit that the Appellee had no "profit" by the transaction, that there had been no "gain" derived from capital, and that no gain had accrued to him, and that under no proper construction of the real facts of this transaction can it be held that the Appellee has "derived" income from this "readjustment of the financial business of the company."

The purpose of the transaction was "to materially increase our capital to provide for proper and economic operation."

The capital and profits of the New Jersey Company were "so far absorbed in the business" which was transferred to the Delaware Company "as an entirety and as a going concern" that the effect thereof was "to render it impracticable to separate them for withdrawal and dis-

tribution;" and this transaction added "nothing to the interests of the shareholders," and the only change was "in the evidence which represents" the interest of the shareholders in exactly the same assets and business.

The New Jersey Company had at one time a large amount in Anglo-French Bonds, which were afterward paid out to the stockholders by a dividend in kind, and upon which income tax was duly paid. If these bonds were among the assets transferred on October 1, 1915, to the Delaware Company, the position of the Government in this case would be that the Appellee must pay a tax on the common stock of the Delaware Company received by him at its market value, which market value was partly based upon the Anglo-French Bonds; and that thereafter, when the bonds were segregated from the assets of the business and distributed to the stockholders that again the Appellee must pay a tax to the Government upon the market value of these bonds. The effect thereof would be to first tax the stockholders upon the assets represented by the stock certificates of the Delaware Company as a whole, and then tax the stockholder upon these assets when distributed to the stockholders. We submit that this could not have been intended by the Income Tax Act.

As an illustration—an investor bought on the 25th day of September, 1915, one share of stock in the New Jersey Company, for which he paid $795, the then alleged market value of the stock. This stockholder's income from other sources was such that if the present law had then been in effect he would have been required to pay 50 per cent of the income received as a tax to the Government. On the 1st of October, 1915, there were issued to the above investor two shares of the stock of the Delaware Company worth in the market at the time $347.50 per

share, and he still held his one share in the New Jersey Company of the par and market value of $100; the result of which was that he had three certificates representing his investment worth exactly the same amount as he had paid for the one certificate in the New Jersey Company. The Government's contention now is that both shares of the Delaware Company's stock are income, and that one share of the stock must be sold and that the $347.50 realized therefrom must be paid to the Government as income tax, and then the purchaser above mentioned would have left one share of the New Jersey Company worth $100 and one share of the Delaware Company worth $347.50, a total of $447.50, in place of the $795 which he had invested and paid for the share of the New Jersey Company. Yet the Government urges that this purchaser of a share of the New Jersey Company has received in that calendar year by this transaction a "gain" or "profit" on his investment, and that the same has been "derived" and "received or drawn" by the investor, who, on the 25th day of September purchased one share of stock in the New Jersey Company.

It is submitted that this illustration clearly shows the illegality of the collection by the Government from the claimant of the sum involved in this case, on the ground that it was a tax on "income."

Another illustration may be used: The estate of A, deceased, was a large holder of the stock of the New Jersey Company. The estate was in the hands of trustees under the will of A, the income therefrom to be paid to a life tenant and at her death to be divided among the remaindermen, named in the will.

On October 1, 1915, the trustees of this estate who held the stock of the New Jersey Company, and who had as-

sented to the plan of reorganization, received two shares of the stock of the Delaware Company for each share held by them of the common stock of the New Jersey Company. If these shares of stock of the Delaware Company were income when received by the trustees under the will they belonged to the life tenant, but if they represented the corpus of the estate held by the trustees prior to this "financial reorganization of the business of th Company" then the life tenant was only entitled to the income received annually therefrom, and the corpus of the estate—the shares of stock of the Delaware Company—must be divided at the death of the life tenant among the beneficiaries mentioned in the will of A.

If the Government's contention in this case be correct, the corpus of the estate of A holding shares of common stock of the New Jersey Company was worth on September 30, 1915, $795.00 for each share of stock so held.

On the 1st day of October, 1915, the entire corpus of the estate of A, upon the Government's contention, was the shares of common stock in the New Jersey Company worth $100 per share, and the life tenant was entitled to all of the shares issued to the trustees by the Delaware Company, and each one of these shares is alleged to have been worth $347.50. In other words, by the reorganization of the Company the corpus of the estate of A lost over night six-sevenths of its value, and the remaindermen were only entitled to the shares in the New Jersey Company of the par value of $100 per share, whereas the day before they were entitled in remainder to the total number of shares, at $795.00 per share.

The estate of A by reason of the death of the life tenant has recently been divided under the will, and of

course the stock in the Delaware Company was properly treated as part of the corpus of the estate. Can there be any doubt that this stock of the Delaware Company "was capital as well for purposes of the Income Tax Law as for distribution between tenant for life and remaindermen?" Towne vs. Eisner, 245 U. S. 418, at p. 426.

The learned Solicitor General cites the case of New York Trust Company, Executors, etc., vs. Edwards, Collector, decided on August 3, 1921, by Judge Learned Hand in the Southern District of New York, in which the learned Court refers to the case of Phellis vs. United States, recently decided by the Court of Claims, and says with reference to the opinion of that Court:

> "Whatever may be the proper answer to the case, with the greatest deference I cannot follow the reasoning of the learned judge now urged upon me as authoritative. That reasoning is that because the joint value of the old and new shares after the transfer was the same as that of the old shares before, there can have been no income to the stockholder."

The fact that the value of the shares of stock held by the Appellee in this case was exactly the same after October 1, 1915, as the shares held by him prior to that date in the New Jersey Company, was merely *one* of the facts relied upon by the Court of Claims in reaching the conclusion that the Appellee had received no taxable income, gain or profit:

The Court of Claims was fully justified in taking this into consideration in view of the opinion of this Court by Mr. Justice Holmes, in the case of Towne vs. Eisner, 245 U. S. 418, at p. 426, as follows:

"What was said by this Court upon the latter question is equally true for the former. 'A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. * * * The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones.' Gibbons vs. Mahon, 136 U. S. 549, 559, 560. In short, the corporation is no poorer and the stockholder is no richer than they were before. Logan County vs. United States, 169 U. S. 255, 261. If the plaintiff gained any small advantage by the change, it certainly was not an advantage of $417,450, the sum upon which he was taxed. *It is alleged and admitted that he receives no more in the way of dividends and that his old and new certificates together are worth only what the old ones were worth before.*" (Italics ours.)

Whatever may be the correct conclusion of the case decided by Judge Hand in which the facts were entirely different from the present case, we submit that it is clear in this case that the Appellee received by the transaction involved no "gains or profits and income," and therefore that the judgment of the Court of Claims should be affirmed.

II.

THE EFFECT OF THIS TRANSACTION SO FAR AS THE STOCKHOLDER IS CONCERNED AND SO FAR AS THE BUSINESS WAS CONCERNED, IS THE SAME AS IF A STOCK DIVI-

DEND HAD BEEN MADE BY THE NEW JERSEY COMPANY, AND THE STOCK RECEIVED BY APPELLEE IN THE DELAWARE COMPANY IS NO MORE GAIN, PROFIT AND INCOME THAN IF HE HAD RECEIVED A STOCK DIVIDEND FROM THE NEW JERSEY COMPANY.

The Court of Claims put its decision upon the ground that the Appellee had received no "gains or profits and income" by the transaction, and did not discuss the question of whether the receipt of the stock in the Delaware Company by Appellee should be treated as "a stock dividend." The learned Solicitor General in his brief and the *one* Assignment of Error (Brief, pp. 9, 10), says:

> "The Court of Claims erred in holding that the dividend paid by the New Jersey Corporation to its stockholders in the stock of the Delaware Corporation was a stock dividend and did not constitute income," etc.

This would seem to indicate that the position of the Court of Claims was misunderstood by the Government, for that Court having decided that there were no "gains or profits and income" did not find it necessary to go further and decide that the transaction in effect was the same as a stock dividend by the New Jersey Company.

The Court below took a view of the situation which we think entirely justified, as follows (R. 22):

> "We think the whole transaction is to be regarded as merely a financial reorganization of the business of the Company, and that this view is justified by the power and duty of the Court to look through the form of the transaction to its substance."

In Eisner vs. Macomber, 252 U. S., 189, at page 213, it is said:

> "We have no doubt of the power or duty of a court to look through the form of a corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable without apportionment."

In the court below, the Government contended, as it does here, "that the New Jersey and Delaware corporations must be regarded as "separate and distinct legal entities" and that the case is within the rule of Peabody vs. Eisner, 247 U. S., 347.

We submit that this is a very narrow view of the transaction. The fact that the New Jersey Company and the Delaware Company were distinct legal entities is not a *controlling* fact. It is evident that the entire business of the Company was to be carried on as one enterprise just as it had been before with the intervention of a technical legal entity incorporated under the laws of Delaware.

Exactly the same situation existed in the case of Southern Pacific Co. vs. Lowe, 247 U. S., 330, and this Court, speaking through Mr. Justice Pitney, said at page 337:

> "We base our conclusion in the present case upon the view that it was the purpose and intent of Congress while taxing 'the entire net income arising or accruing from all sources' during each year commencing with the 1st day of March, 1913, to refrain from taxing that which in mere form only bore the appearance of income accruing after that date while in truth and in substance it accrued before; and upon the fact that the Central Pacific and the Southern Pacific were in substance

identical because of the complete ownership and control which the latter possessed over the former as stockholder and in other capacities. While the two companies were *separate legal entities*, yet in fact and for all practical purposes they were merged, the former being but a part of the latter, acting merely as its agent, and subject in all things to its proper direction and control."

The Delaware Company was simply an agency created by the New Jersey Company to carry on the business theretofore carried on by the New Jersey Company, and all of the assets of the New Jersey Company were turned over to the Delaware Company for that purpose, and the stockholder simply had certificates of interest representing his identical proportionate share in the same assets. The purpose was *not to distribute the assets* to the stockholders as dividends, *but to prevent this very thing* by *fixing* these very *assets as capital*. We submit that "in mere form only" this transaction "bore the appearance of income" to the Appellee, "while in truth and in substance" the Appellee had no greater interest than he had before October 1, 1915.

The case of Gulf Oil Co. vs. Llewellyn, 248 U. S., 71, was also a case where "separate and distinct legal entities" were involved, and the Court said at page 72:

"We are of opinion that the decision of the District Court was right. It is true that the petitioner and its subsidiaries were distinct beings in contemplation of law, but the facts that they were related *as parts of one enterprise*, all owned by the petitioner, that the debts were all enterprise debts due to members, and that the dividends represented earnings that had been made in former years and that practically had been converted into capital, unite to convince us that the transaction

should be regarded as bookkeeping rather than as 'dividends declared and paid in the ordinary course by a corporation.'" (Italics ours.)

The clear purpose had in view by the corporation was to turn all of its business, cash, assets, good will and everything over to the Delaware Company "as an entirety and as a going concern," and the purpose was "to materially increase our capital to provide for proper and economical operation." After the transfer the New Jersey Company "has done no business" (Finding X, R. 20) and the whole "one enterprise" has been conducted by the Delaware Company. All of the assets were to be treated as fixed capital in the business. It is clearly evident that there was no purpose of "segregation of profits" or that any of the assets should be "severed from the capital however invested or employed," but that the entire property of the Company should be used as it had theretofore been used in its business as fixed capital and not to be distributed, and the only difference was that the stockholders should have "three paper certificates representing his same proportional interests in the assets of the Company as before," but the assets were to be fixed so as to "deny him any present participation in the accumulated earnings of the Company."

We submit that the facts in the case of Peabody vs. Eisner, 247 U. S., 347, are so different from the facts of this case that the reasoning of the Court there does not control the question here presented. In that case certain assets of the Union Pacific Railroad Company, to wit, stock of the Baltimore & Ohio Railroad Co. which it held *as an investment*, were taken out of the assets of the Company and distributed to its stockholders. This was "a segregated" dividend of property in kind, exactly the same as when the Delaware Company made a dividend

payable in Anglo-French Bonds, upon which the stockholders receiving the same paid their income tax. The assets of the business in the Peabody case were reduced by the amount of stock distributed, but in the instant case the assets of the business remained exactly the same as they were before the Delaware Company was incorporated, and we submit that this case is not controlled by Peabody vs. Eisner, which involved "a distribution *in specie* of a portion of the assets of the Union Pacific and is governed for all present purposes by the same rule applicable to the distribution of a like value of money."

The whole reasoning of the Court in the case of Towne vs. Eisner, 245 U. S., 418, is applicable to the facts of this case, and while it may be held that the facts here did not show a technical stock dividend, yet in "truth and in substance" the situation of the stockholder and of the assets and business upon which they were engaged was exactly the same, as if there had been a technical stock dividend, and we submit that the case should be held to be within the reasoning of this Court in that case, which was affirmed by the case of Eisner vs. Macomber, 252 U. S., 189.

In the Brief of the learned Solicitor General under the heading, "The Argument From Hardship," it is contended that the enforcement of the assessment against Appellee would create no hardship upon him, and that one share of stock in the New Jersey Company being worth "the full market price of $795.00 per share," that by the "declaration of this dividend the stock had immediately shrunk to $100 per share," and that "it was within his power, and for aught that the record discloses, he exercised that power (which, it is found by the Court,

is not a fact) to sell his stock after the stock sold ex-dividend, for the new market value of $100.

The Brief at page 37 then states:

> "In that event he did not suffer any hardship whatever, for in making up his income account on the debit side he would account for his share of the accumulated profit by admitting a receipt of $695 in value from dividends, and on the credit side he would get a credit for the precise amount of such shrinkage in the value of his stock. Thus he would pay no tax at all. How then was he injured?"

It is quite remarkable that the learned Solicitor General should have overlooked the fact that this assessment is made under the Act of October 3, 1913, and for a loss in decrease of value in the New Jersey stock the Appellee would not be entitled to take credit in making his income tax return, for that Act only allows a deduction from gross income of a "loss incurred in trade." It being therefore evident that the Appellee could have taken no such credit for loss in value of the New Jersey stock, and the Solicitor General being convinced of that fact by an examination of the Act of October 3, 1913, no doubt he will admit the "hardship" that would be suffered by the Appellee, by the affirmation of the Government's contention.

We respectfully submit that the judgment of the Court of Claims should be affirmed.

OCTOBER, 1921.

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Of Counsel.

In the Supreme Court of the United States.

OCTOBER TERM, 1920.

THE UNITED STATES, APPELLANT,
v.
CHARLES W. PHELLIS. } No. ——.

APPEAL FROM THE COURT OF CLAIMS OF THE UNITED STATES.

MOTION BY THE UNITED STATES TO ADVANCE.

The United States, by the Solicitor General, respectfully moves that this case be advanced for hearing on April 11, 1921.

The case involves the construction and application of a revenue law of the United States, namely, the Income Tax Act of October 3, 1913. (38 Stat. 114.)

The question involved and its importance will appear from the following brief statement of facts:

On and prior to September 1, 1915, claimant was the owner of 250 shares, par value $100 each, of the common stock of the E. I. du Pont de Nemours Powder Company, a corporation under the laws of New Jersey, hereinafter called the New Jersey Corporation. This corporation had then outstanding:

5 per cent bonds	$1,230,000.00
4½ per cent bonds	14,166,000.00
Preferred stock (par value)	16,068,600.00
Common stock (par value)	29,427,100.00

In August and September, 1915, pursuant to a proposal to and assent by the requisite number of stockholders of the New Jersey Corporation a plan was carried out by which a new corporation, known as E. I. du Pont de Nemours & Company, was organized under the laws of Delaware. This corporation is hereinafter referred to as the Delaware Corporation. On October 1, 1915, pursuant to said plan, the New Jersey Corporation sold and transferred to the Delaware Corporation all its assets and received in consideration therefor—

Cash	$1,484,100.00
Debenture stock, par value (nonvoting)	59,661,700.00
Common stock (par value)	58,854,200.00

Under this plan the New Jersey Corporation was to and did pay its 5 per cent bonds in cash, retire its 4½ per cent bonds and its preferred stock by exchanging therefor debenture stock of the Delaware Corporation; and distribute the common stock of the Delaware Corporation as a dividend to the common stockholders of the New Jersey Corporation. The common stockholders of the New Jersey Corporation retained their stock in it and received as a dividend two shares of common stock of the Delaware Corporation for each share held of the common stock of the New Jersey Corporation. The New Jersey Corporation was not then and is not in process of liquidation, but is an existing corporation, transacting no business, however, other than to collect income dividends from its Delaware debenture stock and to distribute the same, but still has all its corporate powers; and only its assets and liabilities existing at the time of

sale were assumed by the Delaware Corporation. The personnel of the stockholders and officers of the two corporations was, at the time of the sale, identical.

Mr. Phellis, the claimant in this case, after the sale received 500 shares of the common stock of the Delaware Corporation and continued to hold his original 250 shares of common stock of the New Jersey Corporation. The fair market value of the common stock of the New Jersey Corporation, the day before the sale of its assets to the Delaware Corporation, was $795 per share; the day after the sale the fair market value of such stock was $100 and of the common stock of the Delaware Corporation $347.50 per share.

The Commissioner of Internal Revenue held that the 500 shares of stock of the Delaware Corporation distributed to claimant was taxable income; claimant, after due procedure, paid the tax assessed, $5,657.97, under protest and brought this suit in the Court of Claims to recover the amount so paid on the ground that the dividend of stock in the Delaware Corporation was a stock dividend and not taxable under the decisions of this court in *Towne* v. *Eisner*, 245 U. S. 418, and *Eisner* v. *Macomber*, 252 U. S. 189. The Government contends that the two corporations are distinct entities and that the dividend of stock of the Delaware Corporation held by the New Jersey Corporation was a distribution in specie of corporate property and therefore taxable income under the decisions of this court in *Lynch* v. *Hornby*, 247 U. S. 339, and *Peabody* v. *Eisner*, 247 U. S. 347.

The Court of Claims, on March 14, 1921, rendered judgment in favor of claimant.

It is most important that this case be heard and decided at the present term of this court, if possible. While the amount involved in this particular case is relatively small, it is a test case and the total amount of taxes involved in the distribution of the stock of the Delaware Corporation by the New Jersey Corporation, and distributions similar in principle by other corporations, is enormous. The Government has collected very large sums of money from citizens under the ruling of the Commissioner of Internal Revenue. This money is held without interest and should be refunded promptly if the view of the Government officers is incorrect. In addition, the ruling of the Commissioner of Internal Revenue as to the taxability of a distribution of this character is based upon a conception of the income tax law which applies to many other features of the law. If this conception is erroneous, it is highly important that this be decided as soon as possible so that necessary changes in the laws may be brought to the attention of Congress.

The Solicitor General has been authorized by opposing counsel to state that they join in the request for advancement of this case.

WILLIAM L. FRIERSON,
Solicitor General.
FRANK DAVIS, Jr.,
Special Assistant to the Attorney General.

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UNITED STATES *v.* PHELLIS.

APPEAL FROM THE COURT OF CLAIMS.

No. 260. Argued October 11, 1921.—Decided November 21, 1921.

1. Substance and not form should control in the application of the Sixteenth Amendment and the income tax laws enacted under it. P. 168.
2. The Income Tax Law of October 3, 1913, in declaring that the tax shall be laid on gains, profits and income derived from dividends, means, not that everything in the form of a dividend must be treated as income, but that income derived in the way of dividends shall be taxed. P. 168.
3. Income defined (p. 169) as in *Eisner* v. *Macomber*, 252 U. S. 189.
4. With the concurrence of 90% of the stockholders of a corporation, a plan of reorganization was effected, pursuant to which a new corporation with an authorized capital stock nearly four times as great in par value as the aggregate stock and bonded indebtedness of the old was formed under the laws of a different State, all the assets of the old were transferred to the new, as a going concern, including the good will and a large surplus, and, in consideration, the old corporation retained money enough to redeem part of its bonds and received (1) the new company's debenture stock of par value sufficient to redeem the remainder, retire its own preferred stock and leave in its treasury an amount equal in par value to its own outstanding common stock, and (2) the new company's common stock of par value double the amount of the old company's outstanding common stock, which the latter immediately distributed to its common stockholders as a dividend, paying them two shares of the new for each of the old. Upon completion of the transaction, October 1, 1915, the personnel of the stockholders and officers of the two corporations was identical, the stockholders having pro-

portionate holdings in each; but less than one-half of the new company's authorized stock had been issued. Thereafter, the old corporation continued as a going concern, but, except for the redemption of its bonds and retirement of its preferred stock, and the holding of the debenture stock equal to its common, and collection and disposition of the dividends thereon, did no business. *Held:* (a) The shares of the new company's common stock which passed to the old company and through it to its stockholders as a dividend, representing its surplus, were income of the shareholders, taxable under the Act of October 3, 1913. P. 169. (b) And this, although the market value of the stockholder's old shares before the dividend was the same as that of his old and new shares after it. P. 170. (c) The new company must be regarded, not as substantially identical with the old, but as a separate entity, and its stockholders as having property rights and interests materially different from those incident to ownership of stock in the old company. P. 172. (d) The new common stock in the treasury of the old company being treasury assets representing accumulated profits and capable of distribution, its distribution transferred to the several stockholders new individual property, which they were severally entitled to enjoy or to sell,—their individual income. P. 174.

56 Ct. Clms. 157, reversed.

APPEAL from a judgment sustaining a claim for a refund of moneys paid under protest in discharge of an income tax assessment.

Mr. Solicitor General Beck, with whom *Mr. Carl A. Mapes*, *Mr. Newton K. Fox* and *Mr. Andrew J. Aldridge* were on the brief, for the United States.

The New Jersey corporation could have distributed its large surplus in cash or in specie, either as securities or, if divisible, tangible property. In either case the distribution would have been income. However, it sold its entire plant to a new corporation. The fact that the new corporation was formed by the managing body of the old and that there was a momentary identity of stockholders can not in any way affect the question. They formed the new corporation in another State and with such franchises as that State granted corporations of this character.

Whether these franchises, as granted by Delaware, were the same or different from the franchise granted to the old company by New Jersey does not appear. Presumably, the promoters of the new company found some advantage in securing a different corporate situs.

The new corporation had a much larger authorized capital stock. The relations between the stockholders *inter sese* were likewise changed in regard to the amounts, kinds and proportions of stock authorized. Moreover, the Delaware company retained in its treasury one-half of its stock which was not issued; but, as it was authorized, its possible issue was contemplated. Therefore, potentially, the relative proportions of the common owners of this property would be very much changed, and the stockholders greatly augmented in numbers, if and when one-half of the whole capital stock of the new corporation was, as was possible, sold to the public.

The old company continued its operations as a company. Thenceforth it had the stock in question, out of which it proceeded to retire its bonded indebtedness and, so far as possible, its preferred stock, and it held the precise equivalent of its common stock in valuable interest-bearing assets, and a large surplus, which it divided among its stockholders. Nothing prevented it from taking its existing assets, purchasing a new plant, and competing with the new company. For all legal and practical purposes the two corporations were separate. The identity of management and stockholders were potentially and probably but temporary. And when we are considering whether these corporations are or are not separate entities, the possibilities or powers affect the question quite as much as the temporary realities.

The fact that the distribution of securities by the New Jersey corporation was contemporaneous with the sale of its assets is also immaterial. It is not important when these transactions took place, but what was their essen-

tial character. The controlling question is, Was this distribution by the New Jersey company of Delaware stock a distribution of surplus earnings, or was it merely a duplication of its own certificates, representing the same proportionate interest in the capital assets of the New Jersey company? It is not denied that, whatever the nature of this dividend may be, it represented a distribution of surplus profits, for the capital assets of the New Jersey company remained intact. Moreover, the Delaware stock represented corporate interests in assets, which had been severed from the New Jersey corporation by alienation. Thenceforth the New Jersey stock could not be regarded as representing proportionate interests in the plant and assets thus conveyed; and the New Jersey stockholders owned proportionate interests in securities of another corporation which were not only potentially but in fact different from those of the New Jersey corporation.

The reasoning in *New York Trust Co.* v. *Edwards*, 274 Fed. 952, seems more convincing than that of the court below, which based its conclusion largely upon the inconclusive fact that the market value of the New Jersey and Delaware stock in the stockholders' hands after the dividend was the same as the value of the New Jersey stock before the dividend. This normally happens whenever a corporation declares a dividend. It generally loses in market value by the amount of the dividend, and this is especially true where the dividend is a large or unusual one. Judge Hand bases his conclusion upon the true ground, viz, that the assets which were represented by the Delaware stock were no longer the property of the New Jersey company.

What matters it whether the Delaware stock, which was issued against the assets purchased from the New Jersey company, was distributed as a dividend to the New Jersey stockholders, or the New Jersey stockholders first received the cash and then got the Delaware stock? In

either event, the New Jersey stockholder received cash or its equivalent, for he could sell his Delaware stock for cash without diminishing his proportionate interest in the capital stock of the New Jersey corporation.

The ownership by one corporation, or by the stockholders of one corporation, of the stock of another, does not destroy the distinct legal entity of the two corporations. In cases involving taxation the courts have consistently refused to disregard the principle of corporate entity. *Eisner* v. *Macomber*, 252 U. S. 189, 214. *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; and *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S. 71, are clearly distinguishable from the instant case. There is little similarity between the facts in those cases and the facts in the instant case.

Peabody v. *Eisner*, 247 U. S. 347, is controlling. See *Eisner* v. *Macomber*, 252 U. S. 189, 211; *Towne* v. *Eisner*, 245 U. S. 418, 426.

The dividend in this case was not a liquidation dividend. *Lynch* v. *Turrish*, 247 U. S. 221, therefore, has no application. The limitations of the *Turrish Case* are clearly brought out in *Lynch* v. *Hornby*, 247 U. S. 339.

Fluctuation in market value is not the criterion which determines whether income has been derived from capital, but the segregation of corporate assets, which before segregation represented only an inchoate right of the stockholder, does determine whether income has been received. See *Eisner* v. *Macomber*, *supra*, 208. The dividend came *ab extra* and constituted "a gain derived from capital"—"income derived from any source whatever."

It is immaterial whether the property sold by the old corporation to the new was acquired prior to, or after, March 1, 1913. *Lynch* v. *Hornby*, *supra*.

The argument which evidently impressed the court below is the alleged hardship upon the stockholder. But we are dealing with a distribution of profits which were un-

precedented in size. The case in principle would not differ whether the dividend was large or small in proportion to par value. This court should be very slow in asserting a principle with respect to a dividend of unusual size, which would necessarily be applicable to a very much smaller dividend. The hardship, however, is more apparent than real.

Mr. William A. Glasgow, Jr., and *Mr. Frank S. Bright*, with whom *Mr. J. P. Laffey* and *Mr. C. R. Mudge* were on the brief, for appellee.

The common stock of the Delaware company received by appellee was not "income arising or accruing to him," nor was it "gain or profit derived by him"; it was simply the evidence of his pro rata interest in the assets of the company which it was determined to retain in the business, in increasing the capital, upon a financial reorganization, and was not assessable under the Act of 1913.

It is evident that there was no purpose to distribute any part of the assets of the New Jersey company, but that the purpose was to fix and retain all of the assets, cash and good will in an operating corporation, as capital, and to prevent the distribution thereof to the stockholders, issuing to them, however, additional certificates as evidence of the same proportionate interests in exactly the same assets; and that the plan contemplated the continued operation of the business as an entirety, and under a new charter, as a going concern.

If upon a valuation of its assets the New Jersey company had determined that all of the assets were to be retained as capital, and had issued to its stockholders pro rata common stock based upon this valuation, there could be no contention that the stockholders had received income, gain or profit. This is admitted by the Government.

There is in substance no difference between an issue of common stock as evidence of pro rata interest in the

same assets and business, whether issued by the old company or by the new. It is only a question of form. Before the transaction the stockholder's interest was represented by one certificate,—afterwards by three; and his proportionate interest was the same in the undivided assets, as found by the court below. *Gibbons* v. *Mahon*, 136 U. S. 549, 558, 559; *Eisner* v. *Macomber*, 252 U. S. 189, 207, 210, 213.

On September 30, 1915, a stockholder of the old company having one share held a certificate which he could sell in the open market for $795. This value did not accrue in the preceding calendar year, but was the accumulated value based upon the company's assets. By the reorganization of the old company and the transfer of its assets to the new, the same stockholder held, on October 1, 1915, three shares of stock represented by two certificates based upon exactly the same assets, undistributed, upon which his one share in the old company was based. There had been no segregation of profits; there was no certificate representing a personal gain to appellee, since the certificates new and old are alike in what they represent—a capital interest in the entire concerns of the corporation. The three shares were worth exactly what his one share in the old company was worth on September 30th, and appellee had no profit by the transaction, there had been no gain derived from capital, no gain had accrued to him, and under no proper construction of the facts can it be held that he derived income from this readjustment of the financial business of the company.

The capital and profits of the old company were so far absorbed in the business which was transferred to the new company as an entirety and as a going concern, that the effect thereof was to render it impracticable to separate them for withdrawal and distribution. This transaction added nothing to the interests of the shareholders, and

the only change was in the evidence which represents the interests of the shareholders in exactly the same assets and business.

The old company had at one time a large amount in Anglo-French bonds, which were afterward paid out to the stockholders by a dividend in kind, and upon which income tax was duly paid. If these were among the assets transferred to the new company, the position of the Government in this case would be that appellee must pay a tax on the common stock of the new company received by him at its market value, which market value was partly based upon the bonds; and that thereafter, when the bonds were segregated from the assets of the business and distributed to the stockholders, again the appellee must pay a tax upon the market value of these bonds. The effect would be to first tax the stockholders upon the assets represented by the stock certificates of the new company as a whole, and then to tax them upon these assets when distributed. This could not have been intended by the Income Tax Act.

As an illustration: An investor bought on September 25, 1915, one share in the New Jersey company for $795, its then alleged market value. This stockholder's income from other sources was such that if the present law had then been in effect he would have been required to pay 50 per cent. of the income received as a tax. On October 1, 1915, there were issued to him two shares of the Delaware company worth at the time $347.50 per share, and he still held his one share in the New Jersey company of the par and market value of $100; the result of which was that he had three certificates representing his investment worth exactly the same amount as he had paid for the one certificate in the New Jersey company. The Government's contention now is that both shares of the Delaware company are income, and that one share must be sold and the $347.50 realized thereon must be paid to the

Government as income tax, and then the stockholder would have left one share of the New Jersey company worth $100 and one of the Delaware company worth $347.50, a total of $447.50, in place of the $795 which he had paid for the share of the New Jersey company. Yet the Government urges that this stockholder has received in the calendar year by this transaction a gain or profit on his investment.

Another illustration: The estate of A, deceased, was in the hands of trustees, to pay the income to a life tenant and at his death to divide the capital among remaindermen. On October 1st the trustees received two shares of the Delaware stock for each share held by them of the common stock of the New Jersey company.

If the Government's contention be correct, the corpus of the estate (shares of the New Jersey common stock,) was worth on September 30th, $795 for each share. On October 1st, the entire corpus was the New Jersey stock, worth $100 per share, and the life tenant was entitled to all of the shares issued to the trustees by the Delaware company, worth $347.50 per share. In other words, by the reorganization, the corpus of the estate lost over night six-sevenths of its value.

Can there be any doubt that the Delaware stock was capital as well for purposes of the income tax law as for distribution between life tenant and remainderman? *Towne* v. *Eisner*, 245 U. S. 418, 426.

The fact that the value of the shares held by appellee was exactly the same after October 1st as the shares held by him prior to that date in the New Jersey company, was merely one of the facts relied upon by the court below in concluding that appellee had received no taxable income, gain or profit. The court was fully justified in taking this into consideration, in view of the decision in the *Towne Case, supra.*

The effect of this transaction, so far as the stockholder and the business were concerned, is the same as if a stock

dividend had been made by the New Jersey company. *Eisner* v. *Macomber*, 252 U. S. 189, 213.

The fact that the two companies were distinct legal entities is not controlling. It is evident that the entire business of the company was to be carried on as one enterprise, just as it had been before, with the intervention of a technical legal entity incorporated under the laws of Delaware. Exactly the same situation existed in *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, 337. The new company was simply an agency created by the old to carry on the business theretofore carried on by the latter. In mere form only this transaction bore the appearance of income to appellee, while in truth and in substance appellee had no greater interest than he had before the reorganization. See *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S. 71, 72.

The facts in the *Peabody Case*, *supra*, were so different that the reasoning there does not control.

The whole reasoning of the court in *Towne* v. *Eisner*, 245 U. S. 418, (which was affirmed in *Eisner* v. *Macomber*, *supra*,) is applicable to the facts of this case.

MR. JUSTICE PITNEY delivered the opinion of the court.

The court below sustained the claim of C. W. Phellis for a refund of certain moneys paid by him under protest in discharge of an additional tax assessed against him for the year 1915, based upon alleged income equivalent to the market value of 500 shares of stock of a Delaware corporation called the E. I. du Pont de Nemours & Company, received by him as a dividend upon his 250 shares of stock of the E. I. du Pont de Nemours Powder Company, a New Jersey corporation. The United States appeals.

From the findings of the Court of Claims, read in connection with claimant's petition, the following essential facts appear. In and prior to September, 1915, the New Jersey company had been engaged for many years in the business of manufacturing and selling explosives. Its

funded debt and its capital stock at par values were as follows:

5% mortgage bonds	$1,230,000
4½% 30-year bonds	14,166,000
Preferred stock ($100 shares)	16,068,600
Common stock ($100 shares)	29,427,100
Total	$60,891,700

It had an excess of assets over liabilities showing a large surplus of accumulated profits; the precise amount is not important, except that it should be stated that it was sufficient to cover the dividend distribution presently to be mentioned. In that month a reorganization and financial adjustment of the business was resolved upon and carried into effect with the assent of a sufficient proportion of the stockholders, in which a new corporation was formed under the laws of Delaware with an authorized capital stock of $240,000,000 to consist in part of debenture stock bearing 6 per cent. cumulative dividends, in part of common stock; and to this new corporation all the assets and good-will of the New Jersey company were transferred as an entirety and as a going concern, as of October 1, 1915, at a valuation of $120,000,000, the new company assuming all the obligations of the old except its capital stock and funded debt. In payment of the consideration, the old company retained $1,484,100 in cash to be used in redemption of its outstanding 5% mortgage bonds, and received $59,661,700 par value in debenture stock of the new company (of which $30,234,600 was to be used in taking up, share for share and dollar for dollar, the preferred stock of the old company and redeeming its 30-year bonds), and $58,854,200 par value of the common stock of the new company which was to be and was immediately distributed among the common stockholders of the old company as a dividend, paying them two shares of the new stock for each share they held

in the old company. This plan was carried out by appropriate corporate action; the new company took over all the assets of the old company, and that company besides paying off its 5% bonds acquired debenture stock of the new company sufficient to liquidate its 4½% 30-year bonds and retire its preferred stock, additional debenture stock equal in amount at par to its own outstanding common stock, and also two shares of common stock of the Delaware corporation for each share of the outstanding common stock of the New Jersey corporation. Each holder of the New Jersey company's common stock (including claimant), retained his old stock and besides received a dividend of two shares for one in common stock of the Delaware company, and the New Jersey corporation retained in its treasury 6 per cent. debenture stock of the Delaware corporation equivalent to the par value of its own outstanding common stock. The personnel of the stockholders and officers of the two corporations was on October 1, 1915, identical, the new company having elected the same officers as the old; and the holders of common stock in both corporations had the same proportionate stockholding in each. After the reorganization and the distribution of the stock of the Delaware corporation, the New Jersey corporation continued as a going concern, and still exists but, except for the redemption of its outstanding bonds, the exchange of debenture stock for its preferred stock, and the holding of debenture stock to an amount equivalent to its own outstanding common and the collection and disposition of dividends thereon, it has done no business. It is not, however, in process of liquidation. It has received as income upon the Delaware company's debenture stock held by it, dividends to the amount of 6% per annum, which it has paid out to its own stockholders including the claimant. The fair market value of the stock of the New Jersey corporation on September 30, 1915, prior to the reorganization, was $795

per share, and its fair market value, after the execution of the contracts between the two corporations, was on October 1, 1915, $100 per share. The fair market value of the stock of the Delaware corporation distributed as aforesaid was on October 1, 1915, $347.50 per share. The Commissioner of Internal Revenue held that the 500 shares of Delaware company stock acquired by claimant in the distribution was income of the value of $347.50 per share and assessed the additional tax accordingly.

The Court of Claims, observing that from the facts as found claimant's 250 shares of stock in the New Jersey corporation were worth on the market, prior to the transfer and dividend, precisely the same that the same shares plus the Delaware company's shares received by him were worth thereafter, and that he did not gain any increase in the value of his aggregate holdings by the operation, held that the whole transaction was to be regarded as merely a financial reorganization of the business of the company, producing to him no profit and hence no income, and that the distribution was in effect a stock dividend nontaxable as income under the authority of *Eisner* v. *Macomber*, 252 U. S. 189, and not within the rule of *Peabody* v. *Eisner*, 247 U. S. 347.

We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder. In a number of cases besides those just cited we have under varying conditions followed the rule. *Lynch* v. *Turrish*, 247 U. S. 221; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S. 71.

The act under which the tax now in question was imposed, (Act of October 3, 1913, c. 16, 38 Stat. 114, 166–167), declares that income shall include, among other things, gains derived "from interest, rent, dividends, securities, or the transaction of any lawful business carried

on for gain or profit, or gains or profits and income derived from any source whatever." Disregarding the slight looseness of construction, we interpret "gains, profits, and income derived *from* . . . dividends," etc., as meaning not that everything in the form of a dividend must be treated as income, but that income derived *in the way of* dividends shall be taxed. Hence the inquiry must be whether the shares of stock in the new company received by claimant as a dividend by reason of his ownership of stock in the old company constituted (to apply the tests laid down in *Eisner* v. *Macomber*, 252 U. S. 189, 207), a gain derived from capital, not a gain accruing to capital, nor a growth or increment of value in the investment, but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested, and coming in, that is, received or drawn by the claimant for his separate use, benefit and disposal.

Claimant's capital investment was represented by his New Jersey shares. Whatever increment of value had accrued to them prior to September 30, 1915, by reason of the surplus profits that theretofore had been accumulated by the company, was still a part of claimant's capital, from which as yet he had derived no actual and therefore no taxable income so far as the surplus remained undistributed. As yet he had no right to withdraw it or any part of it, could not have such right until action by the company or its proper representatives, and his interest still was but the general property interest of a stockholder in the entire assets, business and affairs of the company—a capital interest; as we declared in *Eisner* v. *Macomber*, *supra* (p. 208).

Upon the face of things, however, the transfer of the old company's assets to the new company in exchange for the securities issued by the latter, and the distribution of those securities by the old company among its stock-

holders, changed the former situation materially. The common stock of the new company, after its transfer to the old company and prior to its distribution, constituted assets of the old company which it now held to represent its surplus of accumulated profits—still however a common fund in which the individual stockholders of the old company had no separate interest. But when this common stock was distributed among the common stockholders of the old company as a dividend, then at once—unless the two companies must be regarded as substantially identical—the individual stockholders of the old company, including claimant, received assets of exchangeable and actual value severed from their capital interest in the old company, proceeding from it as the result of a division of former corporate profits, and drawn by them severally for their individual and separate use and benefit. Such a gain resulting from their ownership of stock in the old company and proceeding from it constituted individual income in the proper sense.

That a comparison of the market value of claimant's shares in the New Jersey corporation immediately before, with the aggregate market value of those shares plus the dividend shares immediately after the dividend showed no change in the aggregate—a fact relied upon by the Court of Claims as demonstrating that claimant neither gained nor lost pecuniarily in the transaction—seems to us a circumstance of no particular importance in the present inquiry. Assuming the market values were a precise reflex of intrinsic values, they would show merely that claimant acquired no increase in aggregate wealth through the mere effect of the reorganization and consequent dividend, not that the dividend did not constitute income. There would remain the presumption that the value of the New Jersey shares immediately prior to the transaction reflected the original capital investment plus the accretions which had resulted through the company's

business activities and constituted its surplus; a surplus in which, until dividend made, the individual stockholder had no property interest except as it increased the valuation of his capital. It is the appropriate function of a dividend to convert a part of a surplus thus accumulated from property of the company into property of the individual stockholders; the stockholder's share being thereby released to and drawn by him as profits or income derived from the company. That the distribution reduces the intrinsic capital value of the shares by an equal amount is a normal and necessary effect of all dividend distributions—whether large or small and whether paid in money or in other divisible assets—but such reduction constitutes the dividend none the less income derived by the stockholder if it represents gains previously acquired by the corporation. Hence, a comparison of aggregate values immediately before with those immediately after the dividend is not a proper test for determining whether individual income, taxable against the stockholder, has been received by means of the dividend.

The possibility of occasional instances of apparent hardship in the incidence of the tax may be conceded. Where, as in this case, the dividend constitutes a distribution of profits accumulated during an extended period and bears a large proportion to the par value of the stock, if an investor happened to buy stock shortly before the dividend, paying a price enhanced by an estimate of the capital plus the surplus of the company, and after distribution of the surplus, with corresponding reduction in the intrinsic and market value of the shares, he were called upon to pay a tax upon the dividend received, it might look in his case like a tax upon his capital. But it is only apparently so. In buying at a price that reflected the accumulated profits, he of course acquired as a part of the valuable rights purchased the prospect of a dividend from the accumulations—bought "dividend on," as the phrase

goes—and necessarily took subject to the burden of the income tax proper to be assessed against him by reason of the dividend if and when made. He simply stepped into the shoes, in this as in other respects, of the stockholder whose shares he acquired, and presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon. In short, the question whether a dividend made out of company profits constitutes income of the stockholder is not affected by antecedent transfers of the stock from hand to hand.

There is more force in the suggestion that, looking through and through the entire transaction out of which the distribution came, it was but a financial reorganization of the business as it stood before, without diminution of the aggregate assets or change in the general corporate objects and purposes, without change of personnel either in officers or stockholders, or change in the proportionate interest of any individual stockholder. The argument, in effect, is that there was no loss of essential identity on the part of the company, only a change of the legal habiliments in which the aggregate corporate interests were clothed, no substantial realization by individual stockholders out of the previous accumulation of corporate profits, merely a distribution of additional certificates indicating an increase in the value of their capital holdings. This brings into view the general effect of the combined action of the entire body of stockholders as a mass.

In such matters, what was done, rather than the design and purpose of the participants, should be the test. However, in this case there is no difference. The proposed plan was set out in a written communication from the president of the New Jersey corporation to the stockholders, a written assent signed by about 90 per cent. of the stockholders, a written agreement made between the old company and the new, and a bill of sale made by the former

to the latter, all of which are in the findings. The plan as thus proposed and adopted, and as carried out, involved the formation of a *new corporation* to take over the business and the business assets of the old; it was to be and was formed under the laws of a *different State*, which necessarily imports a different measure of responsibility to the public, and presumably different rights between stockholders and company and between stockholders *inter sese*, than before. The articles of association of neither company are made to appear, but in favor of the asserted identity between the companies we will assume (contrary to the probabilities) that there was no significant difference here. But the new company was to have authorized capital stock aggregating $240,000,000—nearly four times the aggregate stock issues and funded debt of the old company—of which less than one-half ($118,515,900) was to be issued presently to the old company or its stockholders, leaving the future disposition of a majority of the authorized new issues still to be determined. There was no present change of officers or stockholders, but manifestly a continuation of identity in this respect depended upon continued unanimous consent or concurrent action of a multitude of individual stockholders actuated by motives and influences necessarily to some extent divergent. In the light of all this we cannot regard the new company as virtually identical with the old, but must treat it as a substantial corporate body with its own separate identity, and its stockholders as having property rights and interests materially different from those incident to ownership of stock in the old company.

The findings show that it was intended to be established as such, and that it was so created in fact and in law. There is nothing to warrant us in treating this separateness as imaginary, unless the identity of the body of stockholders and the transfer *in solido* of the manufacturing business and assets from the old company to the

new necessarily have that effect. But the identity of stockholders was but a temporary condition, subject to change at any moment at the option of any individual. As to the assets, the very fact of their transfer from one company to the other evidenced the actual separateness of the two companies.

But further, it would be erroneous, we think, to test the question whether an individual stockholder derived income in the true and substantial sense through receiving a part in the distribution of the new shares, by regarding alone the general effect of the reorganization upon the aggregate body of stockholders. The liability of a stockholder to pay an individual income tax must be tested by the effect of the transaction upon the individual. It was a part of the purpose and a necessary result of the plan of reorganization, as carried out, that common stock of the new company to the extent of $58,854,200 should be turned over to the old company, treated by it as assets to be distributed as against its liability to stockholders for accrued surplus, and thereupon distributed to them "as a dividend." The assent of the stockholders was based upon this as a part of the plan.

In thus creating the common stock of the new company and transferring it to the old company for distribution *pro rata* among its stockholders, the parties were acting in the exercise of their rights for the very purpose of placing the common stockholders individually in possession of new and substantial property rights *in esse*, in realization of their former contingent right to participate eventually in the accumulated surplus. No question is made but that the proceedings taken were legally adequate to accomplish the purpose. The new common stock became treasury assets of the old company, and was capable of distribution as the manufacturing assets whose place it took were not. Its distribution transferred to the several stockholders new individual property rights which they

severally were entitled to retain and enjoy, or to sell and transfer, with precisely the same substantial benefit to each as if the old company had acquired the stock by purchase from strangers. According to the findings the stock thus distributed was marketable. There was neither express nor implied condition, arising out of the plan of reorganization or otherwise, to prevent any stockholder from selling it; and he could sell his entire portion or any of it without parting with his capital interest in the parent company, or affecting his proportionate relation to the interests of other stockholders. Whether he sold the new stock for money or retained it in preference, in either case when he received it he received as his separate property a part of the accumulated profits of the old company in which previously he had only a potential and contingent interest.

It thus appears that in substance and fact, as well as in appearance, the dividend received by claimant was a gain, a profit, derived from his capital interest in the old company, not in liquidation of the capital but in distribution of accumulated profits of the company; something of exchangeable value produced by and proceeding from his investment therein, severed from it and drawn by him for his separate use. Hence it constituted individual income within the meaning of the income tax law, as clearly as was the case in *Peabody* v. *Eisner*, 247 U. S. 347.

Judgment of the Court of Claims reversed, and the cause remanded with directions to dismiss the suit.

MR. JUSTICE McREYNOLDS, dissenting.

In the course of its opinion, citing *Eisner* v. *Macomber*, 252 U. S. 189, 213, the Court of Claims declared:

"We think the whole transaction is to be regarded as merely a financial reorganization of the business of the company and that this view is justified by the power and duty of the court to look through the form of the trans-

action to its substance." And further, "It seems incredible that Congress intended to tax as income a business transaction which admittedly produced no gain, no profit, and hence no income. If any income had accrued to the plaintiff by reason of the sale and exchange made it would doubtless be taxable."

There were perfectly good reasons for the reorganization and the good faith of the parties is not questioned. I assume that the statute was not intended to put an embargo upon legitimate reorganizations when deemed essential for carrying on important enterprises. *Eisner* v. *Macomber* was rightly decided and the principle which I think it announced seems in conflict with the decision just announced.

MR. JUSTICE VAN DEVANTER concurs in this dissent.